

THE POLITICAL ECONOMY OF INNOVATIVE
DEVELOPMENT FINANCING: A CASE STUDY OF
DONOR FUNDED RISK CAPITAL FINANCING IN
SOUTH AFRICA

Thesis Presented for the Degree of
DOCTOR OF PHILOSOPHY
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Abstract

This thesis sets out to evaluate whether innovative aid modalities have the ability provide more value for money than traditional aid modalities, and if so where? The aim of the research is to contribute to the literature on aid effectiveness and collective action which to date has largely ignored the emergence of innovative aid modalities.

Making use of a case study evaluation the thesis demonstrates that innovative blending mechanisms have the ability to enhance the value for money of development assistance at various points, from initial mobilization to actual absorption. Here the thesis employed a reconstructed program theory to establish to what extent an innovative Risk Capital Facility funded by the European Union in South Africa provided more value than traditional aid delivery modalities. This involved testing both the process of channelling aid, as well as the results achieved.

Although not a panacea to all problems of traditional aid, the results indicate that innovative aid modalities have the ability to translate into higher equilibrium allocations for the donor in terms of aid delivery. Hence from a political economy point of view, the ability of innovative blending to demonstrate value for money may help overcome some of the collective action problems with the traditional aid architecture. This primarily concerned insights into the ability of this innovative aid modality to address issues surrounding institutional turf fights, vested interests, and legitimacy concerns of aid.

*Für meine Eltern:
Astrid und Sven Kühn von Burgsdorff.*

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Yanis Kühn von Burgsdorff

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List of Acronyms

ACP	African, Caribbean, and Pacific
AMC	Advanced Market Commitment
BSS	Business Support Services
CTT	Currency Transaction Tax
CSP	Country Strategy Paper
DAC	Development Assistance Committee
DC	Direct Channel
DEDT	Department of Economic Development and Tourism
DEVCO	Directorate General for Development and Cooperation
DTI	Department of Trade and Industry
EC	European Commission
EIB	European Investment Bank
EQ	Evaluation Question
EU	European Union
FA	Financing Agreement
FAO	Food and Agricultural Organisation
FCU	Finance and Contracting Unit
GBS	General Budget Support
GDP	Gross Domestic Product
GIZ	Gesellschaft fuer Internationale Zusammenarbeit
GNI	Gross National Income
HDP	Historically Disadvantaged Person
IDC	Industrial Development Corporation
IFM	Innovative Financing Mechanism
IMF	International Monetary Fund
IRR	Internal Rate of Return
OECD	Organisation for Economic Cooperation and Development
ODA	Official Development Assistance
OOF	Other Official Flows

LED KZN	Local Economic Development Support Programme in Kwazulu-Natal
MDG	Millennium Development Goal
MIC	Middle Income Country
MIP	Multi-annual Indicative Programme
MOA	Memorandum of Agreement
MOU	Memorandum of Understanding
MTR	Medium Term Review
NFC	Niche Fund Channel
NGO	Non Governmental Organisation
NIF	Neighbourhood Investment Facility
PCM	Project Cycle Management
PCU	Programme Co-ordinating Unit
PDMT	Project Development and Management Team
PPP	Public Private Partnership
PSC	Programme Steering Committee
PSD	Private Sector Development
RCF	Risk Capital Facility
ROM	Results Oriented Monitoring
SABS	South African Bureau of Standards
SBS	Sector Budget Support
SBU	Strategic Business Unit
SEFA	Small Enterprise Financing Agency
SME	Small and Medium Enterprises
TPC	Third Party Channel
UNDP	United Nations Development Program
VfM	Value for Money
ZAR	South African Rand

Introduction

Since the early 1970s, industrialised countries comprising the Development Assistance Committee (DAC) donor club have repeatedly made promises to increase Official Development Assistance (ODA)¹ to eradicate global poverty. Yet the story for the last 40 years has been one of broken promises. This begs the question: why are aid commitments not being met? Moreover, why is most aid still provided via bilateral channels, rendering coordination efforts more difficult?

According to the literature, foreign aid is determined by a number of different factors. International obligations like the Millennium Development Goals (MDG) criteria or European Union commitments to scale up aid have had an impact. The wealth, economic conditions, and welfare state size of the donor country matter too. That's why richer European countries usually spend more on foreign aid measured by share of GDP than poorer donor countries. Power relations and geo-political and economic actors shape the aid effort as well. However, instead of looking at these factors individually, this thesis invokes a political economy approach to elucidate the aid budgeting process.

The starting point of our discussion lies with the premise that donor aid is constrained by entrenched political and economic interests. We argue that there has been one constant in the history of aid, namely that aid has been distorted by vested interests and institutions of donor countries. Consequently predictions concerning donor aid efforts depend on the state of donor interests. It is within this context that the literature surrounding institutions and collective action problems provides an excellent framework to explain the problems of an intricate global aid architecture that is characterised by strategic interactions.

As will be discussed in detail in chapter one, the collective action literature provides us with the analytical tools to explain that the problems with the current aid architecture are systemic and bound to produce sub-optimal results. Here we look at how collective action problems such as free riding and institutional turf fighting affect ODA allocations. In doing

¹ Grants or Loans to countries and territories on Part I of the Development Assistance Committee (DAC) list of Aid Recipients (developing countries) which are: (a) undertaken by the official sector; (b) with promotion of economic development and welfare as the main objective; (c) at concessional financial terms (OECD 2014a).

so the thesis intends to unpack the perverse incentive structures which throw up sizeable barriers to solving many of the deficiencies of development aid. What is more, it explains that, depending on their actions, international development agencies can exacerbate these obstacles or help to reduce them.

The aim of this thesis is therefore to address the central question of how development finance can be made more efficient and effective primarily from the donor perspective. Traditional aid² is one aspect of development finance at the disposal of the DAC members. While there is no panacea to the problems of the aid architecture, donors are constantly in search of aid delivery mechanisms that nod to countervailing domestic interests in donor countries as well as which deliver support transformative change at the recipient level from the outside. Most notably in this context, an increasing number of studies have recently highlighted the role of innovative finance mechanisms for development (Lui and Van Steres 2012; Maxwell 2013). Indeed, persistent development problems in social service delivery and private sector involvement warrant the need for innovative financial solutions. Moreover, developing countries too have been demanding better financial solutions, i.e. risk mitigation efforts with a view to generating private investments, partnerships that mobilise private money for public service delivery, as well as increased support for carbon trading.

To many observers, this development highlights an important shift in the approach of development partners and the way they do business. The context of 2014 is not only hugely different from that of the 1990s, it is even fundamentally changed from the pre-2008 context. The dual challenge of increased financing needs in developing countries coupled with public deficits in donor countries calling for fiscal consolidation and restraint has led to a rethinking of donor aid strategies. While it is clear that in the face of new global challenges large donor institutions such as the European Commission (EC) will increasingly need to evolve, it remains unclear what role innovative aid delivery mechanisms can play. What is more, it is uncertain whether these new forms of aid delivery would ameliorate or exacerbate some of the collective action problems of aid.

Indeed there are queries regarding the ability of new funds to be effectively and coherently allocated in the context of global aid efforts. Issues such as harmonisation and alignment with other donors, as well as country ownership of funding are still a major

²Budget disbursements from traditional sovereign donors via traditional aid channels such as project and program aid, or budget support.

concern. What is more, it remains unclear whether new forms of aid delivery have the ability to abate free riding between donors, and second, the incidence of turf fighting in national budget allocations within donor countries. Consequently the research conducted in this thesis will allow us to consider the potential of innovative finance mechanisms in the context of the collective action discussion. While the literature has researched free-riding and institutional problems of aid, thus far the role of innovative financing in this context has been overlooked. Yet if new forms of aid delivery were to demonstrate greater value for money (VfM), then these mechanisms could play a role in spurring aid efforts. Consequently the research will build on the political economy literature surrounding aid effort, and examine issues surrounding aid effectiveness and the legitimacy of the existing aid architecture.

The core objective of this thesis is thus to examine whether innovative aid modalities have the ability to provide more value for money than traditional aid. While the cornerstones for measuring value for money (VfM) will be defined in chapter four, VfM is generally understood to describe an explicit commitment to achieve the maximum impact possible with the resources that are at the disposal of donor agencies. It is about outcomes and results and requires a plausible causal relationship between money that is spent and outcomes that are achieved. It is not about focusing on the cost only, or choosing the cheapest possible development intervention.

With a view to answering this research question, this thesis conducts an empirical case study evaluation of an innovative Risk Capital Facility financed by the EC in South Africa. While the case study approach is limited as it provides a “snapshot” and is not representative of all innovative blending facilities, it is a very useful approach when the objective is to gain in-depth understanding of a process, especially when the intervention is innovative or experimental or not well understood (Imas, Morra, and Rist 2009).

The aim of the case study was to demonstrate what gains were made that would not have been possible without the innovative RCF. In doing so, it is imperative to understand that the evaluation required an assessment of both the degree of achievement of the donor’s objectives with regard to aid delivery, as well as the process of channelling aid. Hence the evaluation focuses on objectives in terms of both the delivery of aid to the beneficiaries, as well as the effectiveness of the process itself, i.e. what the transaction costs of this innovative aid delivery mechanism were. Here the case study approach was vital in demonstrating the

value of innovative blending at various levels of aid delivery compared to the traditional aid delivery mechanisms.

Finally, the line of argument of this thesis essentially follows an inductive approach. Chapter one will examine the literature on the factors that determine the amount of aid that donor governments give before drawing on the modern literature on institutions and collective action to explain why business as usual, via traditional ODA channelling, faces systemic shortcomings. Next, chapter two will provide an overview of the evolution of the different aid modalities and their discontents, while chapter three will consider the role of innovative finance mechanisms in general, and innovative blending in particular. Ultimately, new aid modalities need to be evaluated and tested to establish their added value and complementarity, hence chapter four introduces the concept of value for money and the methodology for evaluating it. Chapter five will discuss the results of the case study evaluation, while chapter six will offer some key findings before highlighting a number of ways to expand on this research. Finally, chapter seven will draw on the evaluation results and the political economy discussion to formulate a number of conclusions.

1 Domestic Politics and Aid: Why Are Donor Commitments Not Being Met?

With a view to highlighting the state of the current aid architecture, this chapter commences with a brief overview of the status of donor commitments, demonstrating that foreign aid is consistently under-provided and constrained by high negotiation and transaction costs. With a view to explaining this phenomenon, this chapter first examines the disparate literature on what factors determine the amount of aid that donor governments give. Here we identify the different streams of thought with regard to why donors are falling short of their commitments and what determines donor aid allocations. While this literature explores various cultural, political and economic factors to explain why aid budgets are constrained we have to look beyond these isolated factors. Consequently this chapter will introduce the political economy literature surrounding collective action problems of aid to analyse the decision-making procedures and institutional arrangements constraining the traditional aid architecture. This will serve to elucidate the aid budgeting process and better explain why commitments are not being met. In doing so this chapter will demonstrate that the traditional aid architecture consists of complex aid delivery systems which are prone to creating sub-optimal outcomes and perverse incentives.

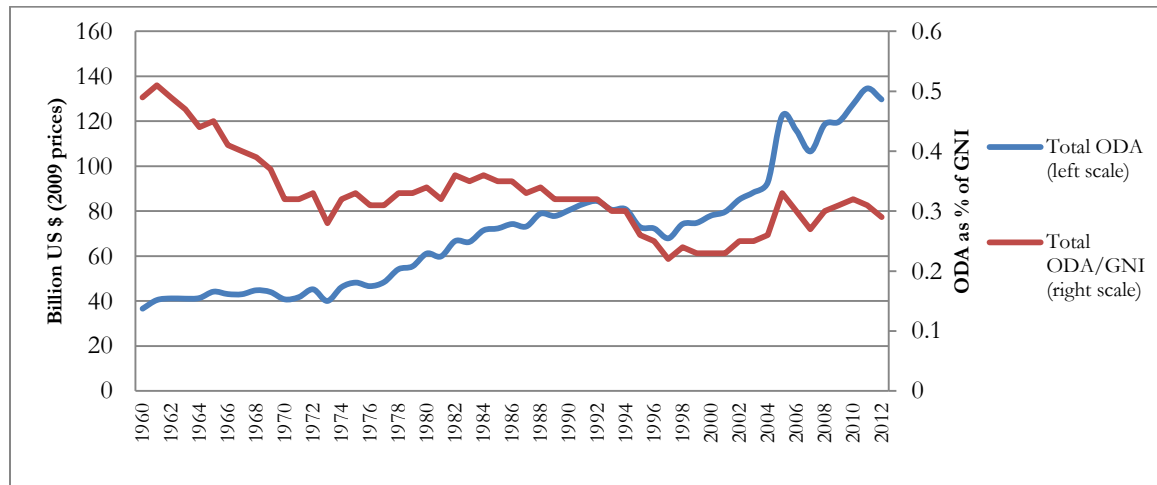
1.1 Commitments of Donor Community: The Elusive 0.7% Target

In 1970 the United Nations General Assembly set a target for donor countries to scale up their ODA to 0.7% of Gross National Income (GNI) by the middle of the decade. Since then over 40 years have passed, yet only Sweden, Norway, Luxembourg, Denmark, and the Netherlands have kept their promise and met this target. Indeed, the story of donor aid efforts since that initial commitment is one of broken promises.

While aid volumes did not increase in the 1970s and 1980s, the 1990s saw aid falling both in nominal and real terms (see Figure 1.1). At the turn of the millennium, a new set of

development targets (the Millennium Development Goals) agreed by world leaders reignited discussions surrounding the old 0.7% target.³

Figure 1.1: Net ODA for DAC Donors (1960-2014)



Source: OECD (2014).

Riding on the wave of optimism following the Millennium Summit in 2000, the first international conference on financing for development was held in Monterrey, Mexico, in 2002. Between 2002 and 2006, Monterrey spawned increased ODA commitments, new initiatives in Gleneagles and Barcelona, debt relief, and the Paris Declaration on Aid Effectiveness. In 2008, the follow up conference on Financing for Development was held in Doha. What is more, as part of the public pressure, EU heads of state and government confirmed the 0.7% commitment in 2010, making the EU the only DAC donor to formally subscribe to the 0.7% target by 2015 (Council of the European Union 2010).

Since Monterrey there have been some encouraging developments. In particular debt relief measures have helped, and the 2008 financial crisis had only a marginal impact on African growth figures (World Bank 2014). Donor approaches have become less intrusive with more aid being given in the form of budget support, directly financing the national budgets of partner countries. Additionally, following the drop in aid efforts in the 1990's, DAC ODA more than doubled between 2002 and 2010, reaching the nominal value of

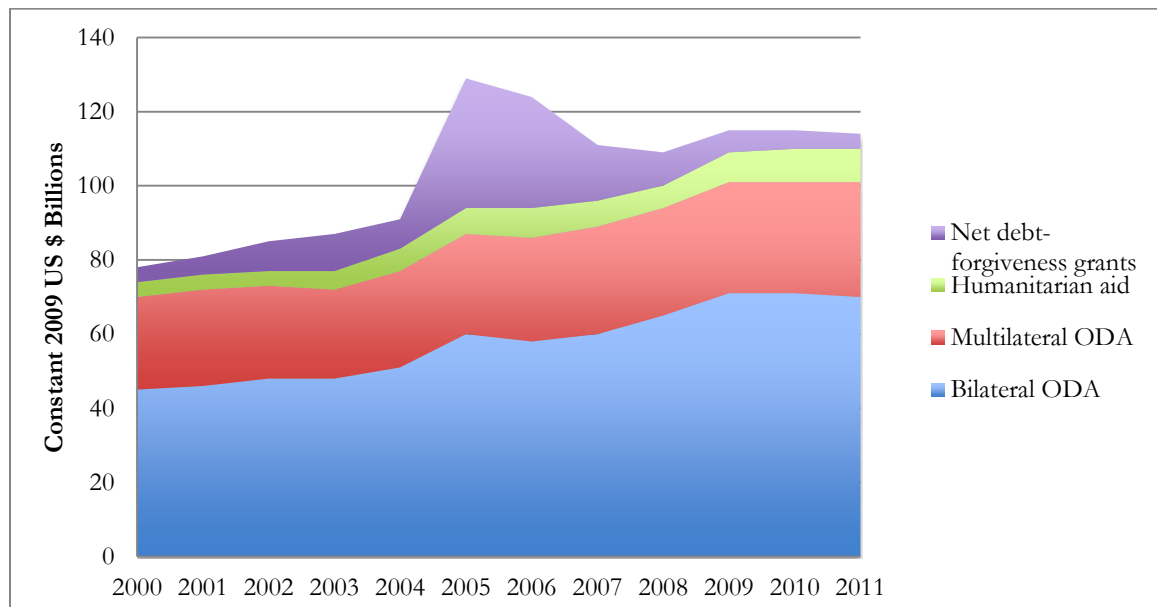
³For an overview of individual aid commitments by DAC member countries and the composition of DAC aid please refer to Appendix A.

US\$ 129 billion, representing 0.32% of members' combined gross national income (OECD 2014).

A more nuanced analysis, however, tells a far less optimistic story. Indeed, the increases in aid over the last decade have been far too small to reach the 0.7% target and post financial crisis ODA commitments are declining in real terms (OECD 2013). When measured against the proportion of the donor countries' GNI, ODA is now at 0.32%, which is roughly the same level it was in 1990. Moreover, in 1960 ODA represented 0.56% of GNI. This means that in relation to their national income, donor countries are giving almost half of the amount of aid they were giving in the early 1960s, a time when they were not nearly as rich as they are today (Hirvonen 2005).

At this stage, most DAC donors are thus falling short of their commitments and as we have illustrated above, historical evidence suggests that promises to scale up ODA are very ambiguous. Moreover, aid continues to be given predominantly via bilateral channels rather than multilateral ones. As Figure 1.2 demonstrates, bilateral development projects continue to dominate the overall aid channelled by DAC donors, thus incurring high negotiation and transaction costs for both donors and recipients alike (Mascarenhas and Sandler 2006).

Figure 1.2: Proportion of DAC Aid Through Different Channels



Source: OECD (2012a).

1.2 What Determines Donor Aid Efforts? A Literature Review

While the 0.7% target is an arbitrary number and has been criticized by some development experts, it allows for comparison between donor aid efforts and represents a commitment to prevent donors from cutting development assistance. Indeed, scaling up aid efforts together with improving coordination is important as many developing countries today still lack finance to foster economic growth and development.

The aim of this section is to provide an overview of the literature surrounding determinants of donor aid efforts. So far the empirical research on aid has primarily focused on aid implementation. However the focus of this thesis surrounds the fact that aid commitments are not being met and that aid continues to be given via bilateral channels. While much less attention has been given to the determinants of donor aid efforts, several studies do exist. According to these studies, there are a number of causes that may account for the amount of aid and its variation across donor countries. With a view to addressing these, the literature can generally be divided into two broad categories of explanatory factors: economic and political (Tingley 2010).

With regard to political factors, one place to start is to recognise that historically aid was first used as a foreign policy tool (Morgenthau 1962; Lancaster 2007). As will be discussed in detail later, since the advent of modern development assistance, much aid has been given out of strategic self-interest. In some cases foreign aid may even be used to systematically disadvantage other countries. For instance, during the cold war, the United States provided its aid predominantly to strategic partners in Europe and the Middle East. Furthermore motives for giving aid in the United States have ranged from concerns over communist governments in Central America, to strategic interests in the Middle East, as well as the need to secure military presence in South East Asia. As a result a number of authors have focused on geo-strategic features which affect donor aid efforts (Liska 1960; Morgenthau 1954; Hoadley 1980; Griffin 1991; White 2001; Round and Odedokun 2004).

In other cases the motive was overtly diplomatic. France, for instance, has been providing development aid primarily as a tool to maintain its sphere of influence in former colonies following their independence. Similarly, British aid was borne out of the colonial legacy of the United Kingdom. While aid certainly continues to act as a tool for strategic interests, the extent to which this is the case remains open to empirical question.

Apart from strategic and diplomatic interests, another stream of research has examined whether there is a link between the political culture of a donor country and the amount of aid it gives? Another way of putting it is to say that we expect that a government's general orientation toward redistribution will influence the level of foreign aid that it provides. According to Noel (1995, 2000) and Lumsdaine (1993) this is the case. Indeed, both demonstrate that donors with a large welfare state at home tend to be more generous when re-distributing money abroad.

Adding to the debate, another set of authors focused on the role of domestic political ideologies in determining donor government aid efforts (Fleck and Kilby 2001; Milner and Tingley 2010). While there are some studies which point out that left wing governments give more aid (Lumsdaine 1993; Chong and Gradstein 2008; Tingley 2010), others suggest that right wing governments are more generous (Goldstein and Moss 2005; Round and Odedokun 2004; Bertoli, Cornia, and Manarosi 2008). What is more, one study finds that political orientation has no significant effect on aid efforts (Dang, Knack, and Rogers 2009). Consequently there is no real consensus on how political ideology affects donor aid commitments.

Concerning economic factors, economic theory dictates that any pressure on donor government budgets is likely to decrease donor government aid efforts (Beck, Clark, Groff, Keefer, and Walsh 2001). As with political factors, the literature considers a number of different economic factors in the context of this discussion. For instance, one stream looks at the role of increasing trade related inter-dependence between donor and recipient countries with regard to aid efforts (Haggard and Moravcsik 1993; Van der Veen 2011). These studies suggest that donor countries which are engaged in more trade with recipient countries are more likely to maintain or increase aid levels. Indeed, commercial self-interest seems to be a powerful determining factor in the provision of aid. According to Lancaster (2007) and Cumming (2001), both France and England have used their development aid to advance the commercial interests of French and British industry via tied aid and non-competitive bidding.

Other authors focus on the role of government debt in donor countries on aid spending (Faini 2006; Bertoli, Cornea, and Manarsi 2008). They find that growing debt constrains aid efforts. Conversely, Round and Odedokun (2004) find that fiscal imbalance has little or no

effect on aid spending, but find that as real per capita income increases in donor countries, so does aid.

Examining the effect of financial crises on aid efforts, Frot (2009) examined six empirical cases over the last forty years and finds that aid by donor countries fell on average by 13% following the crises. Moreover, Dang, Knack and Rogers (2009) find that the effects of banking crises' are especially adverse on aid levels, estimating that the 2008 financial crisis will depress aid by 20-30% over the next decade.

Looking at these factors individually adds to the discussion. However, any comprehensive account of what determines aid levels needs to consider both political and economic factors in tandem. One cannot cast these as alternative explanations. To give an example, Bertoli et al (2008) try to explain Italy's consistently low record of ODA spending by looking at specific macroeconomic characteristics. The authors find that even though macroeconomic factors play a significant role in donor aid spending, they did not fully account for the poor Italian aid record. In fact, even when controlling for these determining factors, Italy was still lagging behind the Organisation for Economic Cooperation and Development (OECD) average, challenging the claim that the poor Italian aid effort can be fully explained by binding fiscal constraints.

Hence it seems that foreign aid is determined by a number of different factors. International obligations like the MDG criteria have an impact. The wealth, economic conditions, and welfare state size of the donor country matter too. That's why richer European countries usually spend more on foreign aid as a share of GDP than poorer donor countries. Power relations and geo-political and economic actors shape the aid effort as well. However, to elucidate the aid budgeting process and better explain why commitments are not being met, this thesis invokes a political economy approach, emphasizing the collective action problems of aid. In particular, the role of vested interests, free riding, and bureaucratic inertia will be emphasized. In doing so the following section will look at how decision making processes of donor aid institutions affect ODA allocations, and what role selective incentives can play in overcoming some of these shortcomings.

1.3 Collective Action Problems of Aid

Following a brief overview of the political economy literature surrounding collective action problems of aid, this literature will provide us with an analytical framework to explain why donor commitments are falling short and why various actors fail to contribute to the production of joint benefits. This approach integrates both the question as to how and why aid is given, identifying several types of obstacles under the concepts of public goods problems, institutional turf fighting, prisoner dilemma implications, and principal agent problems. On the basis of this discussion, the following section will discuss the evolution of the various aid modalities and their discontents before invoking the role of innovative financing and its ability to overcome some of these collective action problems.

1.31 Collective Action Problems of Aid: A Literature Review

In this thesis, we use the modern literature on institutions and collective action problems to explain the process of aid giving. While the literature on this topic is limited, earlier theoretical work by Dudley and Montmarquette (1976), Mosley (1985), and Hatzipanayotou and Michael (1995), emphasize the public good aspect of aid. This is echoed by more recent works, including Steinwand (2012), who states that:

In this uncoordinated and non-hierarchical international environment, developmental policies exhibit classic public goods properties. Any donor can benefit if others do the work, and there is no rivalry in enjoying the benefits.⁴ (Steinwand 2012 p. 3)

According to Olson's (1965) theory of collective action, individuals in groups working to provide public goods are confronted with incentives to 'free ride' on the efforts of others. The underlying premise of Olson's theory is that non-cooperation in the common pursuit of a public good will lead to the undersupply of the good in question; in this case aid. As with

⁴A pertinent example could be one donor country's efforts to create peace and economic security in a given developing country. As the resulting benefits can be shared by all regional countries, this constitutes a public good.

other public goods, there is no rivalry of consumption, nor any way of excluding other donors from enjoying the benefits of development through aid delivery. Consequently Olson's theory suggests that the rational donor has no interest in the absence of selective incentives in voluntarily contributing to a collective action that is to produce public or collective goods since any gain goes to everyone in the group.

In applying Olson's work, a number of political economy studies have been released in recent years making the case that traditional aid efforts are constrained by free-riding problems. This existing work can be divided into several streams of research. First, this thesis draws from the limited literature strongly influenced by the new economics of institutions. One of the key scholars in this field is Ostrom who has examined institutional solutions to common pool resource problems (Gibson, Andersson, Ostrom and Shivakumar 2005). Ostrom describes how asymmetric information, principal agent problems, and additional structural factors constrain the choices of aid providers and recipient governments.

Second, the more recent debate surrounding the fragmentation of aid efforts deals primarily with the lack of coordination in aid policy implementation, however not with regard to aid allocations. Easterly (2007) as well as Frot and Santiso (2010) point out recipient authorities are overburdened with administrative requirements due to the increase in aid providers. Maxwell explains this phenomenon by making use of the 'Prisoners Dilemma theory' (Barder, Gavas, Maxwell, and Johnson 2010). Here collective action problems arise which could only be overcome by increased cooperation between donors.

Finally, a third stream investigates strategic interactions between donor countries as well as turf fighting within donor countries (Vaubel 1986; Steinwand 2012). Steinwand (2012) makes the case that due to the scarcity of resources in donor countries, donor agencies face powerful incentives to free ride in the aid system as well as inter agency rivalry.

In building on these streams of research, the next section will discuss collective action problems such as free riding, turf fighting, principal agent problems, and prisoner dilemma implications to explain that the problems with the current aid architecture are systemic and bound to produce sub-optimal results. In doing so we predict that the political and economic factors arising from the economic downturn in donor countries are likely to accentuate these systemic problems.

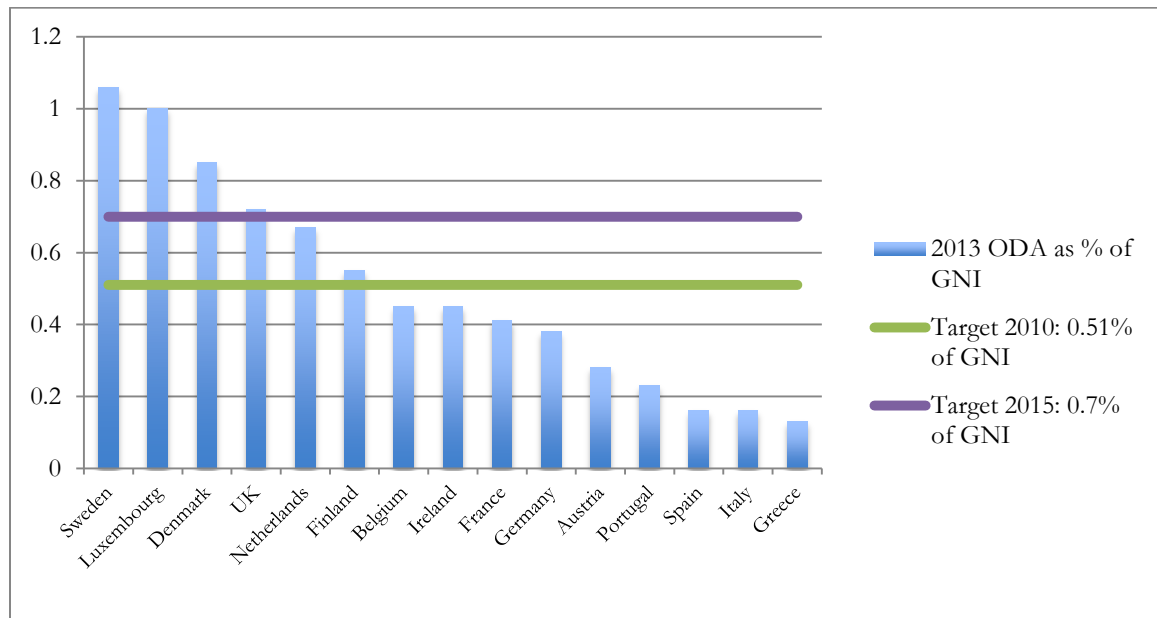
1.32 Collective Action Problems of Aid: Systemic Problems

In a perfect world, promises would be kept and aid untied from vested interest. However, as mentioned above, donors are increasingly falling behind their commitments. As the literature on aid determinants demonstrates, economic and strategic interests are key determinants of aid flows. However the literature also points to a number of additional factors which help explain variations in aid efforts between donor countries. These include cultural characteristics, national identities, domestic political institutions, power status, as well as the existence of a welfare state within the donor country. Indeed, these factors help explain why countries such as Sweden and Denmark have such high ODA commitments, while the United States provides relatively little in official aid.

The aim of this thesis, however, is not to explore the individual interests of donors when giving aid. Rather it seeks to provide a framework to explain how much and what kind of aid donors give in a context that is characterised by strategic interactions and collective action problems. In doing so the literature outlined above helps elucidate why aid continues to be given in a non-cooperative manner.

In the context of Olson's (1965) theory of collective action problems, this section starts by looking at what determines the amount of aid that donors give. Here the incidence of free riding between donors, and second, the incidence of turf fighting in national budget allocations within donor countries serve as analytical tools. With regard to the first point, individuals in groups working to provide public goods are confronted with incentives to 'free ride' on the efforts of others. As mentioned above, the starting point of this approach is to recognise that under certain circumstances ODA and poverty alleviation efforts are fundamentally considered public goods. In economic theory, public goods are characterized by non-rivalry and non-excludability in consumption. Indeed, the provision of aid by one donor has a positive effect on all donors: if one donor provides more aid it has a positive non-excludable/non-diminishable effect that other donors can take advantage of. Hence while donor countries recognize the benefits of maintaining close economic and political ties with one another, some countries may take advantage of the generosity of others (Barder et al 2010). This form of non-cooperation among DAC donor countries ultimately leads to the undersupply of the good in question, in this case aid.

Figure 1.3: EU Donors Falling Short of Commitments (ODA as a % of GNI)



Source: OECD (2014).

Based on an empirical evaluation of 15 OECD donors between 1970 and 2001, Mascarenhas and Sandler (2006) find that aid is predominantly given in a non-cooperative manner and is subject to free riding. A prime example is that of Italy. While most EU member states have been maximising their efforts to reach 0.7% of ODA/GNI in accordance with their international commitments, Italy has been maintaining its current level of less than 0.2% (see Figure 1.3).

This phenomenon is perhaps easier to understand when considering free riding predictions in the context of donor utility functions. Different actors have different interests in different countries, and therefore different rationales for development.⁵ As Manning (2012) writes:

Humanitarian situations apart, official bilateral international concessional transfers normally reflect a mixture of what might be called ‘direct national interest’, ‘broader national interest’ and a more altruistic ‘developmental’ concern with deep and chronic poverty ... restraint on direct national

⁵ This holds both for nation states as well as supranational institutions with their own development budgets such as the EU.

interest is easier to sell in relation to countries which are far poorer than the donor and present minimal political or commercial opportunities. (Manning 2012 p. 22)

While commercial and strategic interests persist, one could argue that two decades after the end of the cold war, aid has increasingly been targeted at the promotion of democracy and with a genuine interest in development objectives.⁶ Consequently progress in terms of taking aid policies and the pursuit of democratic objectives serious have strengthened the public good nature of aid, and thus increased temptations for donors to free ride on the efforts of others.

However DAC donors also share economic and geo-political interests (Steinwand 2011). As early as the 1950s the United States argued that since the efforts to stave off communism via aid would benefit all members of the Free World, there should be an equal sharing of the burden amongst those countries (Hjertholm, Laursen, and White 2000). Today traditional donor countries increasingly share interests. France for instance gives a large share of its bilateral aid to its former African colonies. Yet promoting stability and economic growth in the former French colonies of northern Africa is a shared interest for all European Union countries, and thus constitutes a public good.

Similar to Europe's relationship with northern Africa, shifting global patterns of wealth, poverty, trade, and geopolitical power are constructing new opportunities and challenges for donors in MICs. For instance, the EU continues to provide a substantial amount of aid to South Africa, a country with a higher GDP per capita than Bulgaria (Herbert, 2013).⁷ EU member states have suggested that the EU and South Africa share common values:

South Africa and the EU share many common values and beliefs, making them natural partners to promote development, socio-economic and political progress, as well as stability in a globalising world (Council of the EU 2007e p. 1).

⁶What is more, according to Steinwand (2012), aid data confirms that the new challenges with international terrorism have not led donors to simply revert to the old ways of unconditional support for authoritarian regimes.

⁷ With an indicative grant-based bilateral aid budget of EUR 980 million for the period 2007-2013, the EU funds a variety of initiatives in South Africa (European Commission 2007).

Additionally South Africa has become a launch pad for development initiatives in the region, providing a safe and comfortable location for development agencies to be based to pursue regional activities. More importantly, however, South Africa and its neighbouring countries are becoming increasingly important for trade, access to natural resources, as well as security and diplomatic relations (European Commission 2012). Here development assistance has the ability to serve as a tool to secure and consolidate relationships with recipient governments.

While the variation in free riding could be explained by a mere variation in preferences, Steinwand (2012) provides important insights into this discussion. He clarifies that, first, the differences in free riding can be explained by the fact that donors face different marginal costs of aid delivery, and, second, that there is a path dependency related to donor aid efforts.⁸ He cites the work of Olson and Zeckhauser (1966) who show that differentials in marginal cost of providing a public good will lead to asymmetrical contributions. Here the marginal costs of aid delivery concerns not only the cost of aid delivery, but the overall cost/benefit analysis of the donor's utility function⁹ when providing development assistance. As Steinwand (2012) notes:

Donors face varying marginal costs of providing aid. For example, there is evidence that former colonial ties make aid provision less costly in political terms. Sources of this are notions of historic responsibility and support for co-nationals that remain settled in the former colony. The same cost reduction logic applies to aid that furthers economic goals of the donor. (Steinwand 2012 p. 5)

Consequently Steinwand argues that donors with a low marginal cost of providing aid give more, while those with a high marginal cost free ride on the contributions of others. Moreover, high cost donors may further adjust their contributions downwards since they benefit from higher contributions of low cost donors, thereby further increasing free-riding

⁸As an example he cites evidence that aid to former colonies ties is less costly in political terms (Steinwand 2012 p. 5).

⁹The donor's interests, which can broadly include strategic, economic, and altruistic motives.

losses. As mentioned above, the repeated nature of aid giving implies that this dynamic is reinforced over time.

The concept of diverging marginal costs in the provision of aid provides an intellectual framework to integrate the expansive literature on aid determinants outlined earlier in this chapter. What is more, Steinwand (2012) adds another important consideration to the discussion. Namely that one would expect the presence of self-interested goals by the donor to lead to positive spill ins and a reduction of free riding behaviour by the benefitting donor. Indeed, Olson's theory suggests that the rational donor has no interest in the absence of selective incentives to voluntarily contribute to a collective action. As will be discussed later in this thesis, understanding if and when selective incentives can help to overcome these tendencies therefore provides an important building block for a better aid system.

While free riding is part of the answer as to why donors are falling short of their financial commitments, the literature identifies a second collective action problem in the provision of aid. This problem surrounds the existence of turf fighting in national budgetary allocations which prevent development agencies in donor countries from scaling up aid efforts. With a view to explaining this, a logical point of departure is to look at the institutional process by which aid is allocated.

Within donor governments, ODA amounts are decided in national budget allocations which fall under majority voting in national parliaments. Here the process of donor aid allocations can be characterized as a "compulsory negotiating system" (Scharpf 2006), or as a multiple-veto system (Tsebelis 2002) in which policy choices are shaped by the institutional self-interests and policy preferences of key decision makers in governments. Consequently, competing interests in budgetary decisions prevent those actors interested in reform from reaching agreement while leaving others the opportunity to opt out (Scharpf 2006). Such a situation is likely to arise when fundamental economic interests must be sacrificed, policy change requires an ideological commitment, or when institutional conflict exists. In the wake of exploding budgetary deficits throughout the developed world, we are witnessing all three phenomena on a magnified scale.

In the G-20 countries, overall deficits increased by 4.7 and 3.9 percentage points of GDP respectively in 2012 and 2013, both in comparison to 2007 pre-crisis levels and discounting losses from financial sector support (IMF 2013). Many of these economies continue to implement strategies to contain public debt and cut deficits where possible. This

development is bound to intensify ideological differences between ministries with fundamentally different objectives.

Development agencies in donor countries are traditionally constrained by other lawmakers and ministries higher up in government (Steinwand 2012). To give a concrete example, the House of Lords' Economic Affairs Committee in the UK recently called for the government to abolish its promise to increase ODA to 0.7% of gross national income by 2015. Similarly, Republicans in the U.S. House of Representatives put forward concrete plans in the 2011 budget negotiations to drastically cut foreign assistance.

Altruism tends to begin – and often ends - at home, especially in times of fiscal pressure. According to the literature on determinants of foreign aid, however, there is “no evidence of an association between the generosity ratio (ODA/GDP) and domestic pro-poor government spending, or that right-wing governments are more parsimonious than left-wing ones” (Round and Odedokun 2003 p. 20). Rather the role of institutional conflict in the form of vested bureaucratic interests in maintaining budget allocations presents a major challenge to reaching aid commitments.

Bureaucracies tend to defend the status quo and, by definition, their turf (Vaubel 1986). Here aid agencies are at a perennial disadvantage compared to other government agencies, given foreign aid has no natural domestic constituency. Indeed there is abundant evidence that aid agencies are constrained by inter agency rivalry and actors higher up in the government (Steinwand 2012). This is all the more the case given that donor resources are scarce and providing aid is costly. In the United States, Germany and Japan different aspects of ODA assistance are constantly being shifted from one government agency to another (Lancaster 2007). As a result, agencies compete for resources. Congleton (1982) maintains that bureaucratic inertia becomes a self-perpetuating process and complicates dramatic changes from one budget year to another.¹⁰

This implies little room to manoeuvre for development agencies which are constantly constrained by more powerful domestic interests claiming government resources. Given that objectives are fundamentally different, aligning calls for larger ODA budgets with fiscal conservatism in parliamentary budget decisions is therefore more than likely to end in hold

¹⁰ Similarly, Imbeau (1989) makes the case that institutional inertia is the key explanation for aid levels. Building on these findings, Breuning and Ishiyama (2003) confirm this view and argue that it is also the reason for the dispersion of aid.

up problems. Given the magnitude of public deficits in donor countries, fiscal austerity and competing interests at the national level are likely to intensify in the coming years. As a result, reaching the agreed ODA figure of 0.7% of GDP by 2015 is almost certainly not going to be achieved via traditional development finance channels.

While free riding and institutional turf fighting make it difficult to scale up aid, Mascarenhas and Sandler (2006) argue that aid is also given in a non-cooperative manner and thereby incurs high transaction costs. This is backed by the figures, which indicate that there is little evidence of cooperation. The starting point of our discussion therefore rests on the assumption that donors do not coordinate their aid efforts. Despite limited academic work on the topic, there exists a general consensus that much more needs to be done to improve coordination and counter the continued bilateralisation of aid (Steinwand 2010; Easterly 2007; Frot et al 2010).

Maxwell (2004) argues that the benefits of multilateral aid over bilateral aid include economies of scale, cost-effective procurement, less political interference, greater credibility in developing countries, as well as more democratic governance. Conversely, Djankov, Montalvo, and Reynal-Querol (2006) and Knack and Rahman (2007) demonstrate that the continued bilateralisation of aid has led to lower economic growth and poor institutional performance in recipient countries. What is more, with the increasing number of donor platforms and aid providers, administrative requirements are increasing, making it ever more difficult for local authorities to implement donor demands (Steinwand 2012).

With a view to explaining the continued bilateralisation of aid, the underlying problem of vested interests also explains why aid continues to be so uncoordinated. Indeed, here free riding leads to the continued bilateralisation of aid efforts in the pursuit of own economic and strategic interests. Maxwell (2004) invokes the Prisoners Dilemma theory to help explain this phenomenon. Originally framed by Flood in 1948, the Prisoners Dilemma can be used to explain that for reasons of increasing coherence between donor approaches, reducing transaction costs and market failure, as well as assuring accountability one would expect that governments would want to channel aid multilaterally rather than bilaterally. However, given strong incentives for maintaining their bilateral *modus operandi*, this is not the case. Not only does the decision whether or not to provide aid depend on the context of donor interests, but so does the composition of the aid that is provided. Indeed, while the eradication of global poverty may be a shared moral endeavour and constitute a public good,

the previous sections highlighted that donors also provide foreign aid in the pursuit of their own national interest, i.e. to win commercial contracts, claim mineral resources, or gain strategic advantage over other countries.

Both Germany and Japan used commercially oriented aid policies to assist their export driven economic recoveries following the end of World War II (Steinwand 2012). In Germany aid financing infrastructure projects benefitting the export of German products were given strong policy support throughout the 1970s and 1980s. In Japan a combination of oil shocks and agricultural shortages led to aid efforts targeted at securing access to raw materials. For instance, Japan targeted its bilateral aid towards infrastructure projects in oil producing countries such as Brazil (Lancaster 2007). This served both to gain access to raw materials as well as benefitting the competitive position of Japan's industries and service providers via infrastructure and equipment purchases.

Ultimately, entrenched political and economic interests in donor countries prevent an optimal use of development resources. Barder et al (2010 p. 12) maintain that "Everyone is better off when aid is untied from commercial interests...but each individual agency has an incentive to tie their own aid". This leads them to conclude that "A system of coordination among the donors is needed to ensure that their actions are aligned with their collective interest in poverty reduction, and this is not undermined by pursuit of individual national interests" (Barder et al 2010 p. 12).

In addition to free riding, institutional turf fighting, and prisoner's dilemma problems of aid, the traditional aid architecture also suffers from legitimacy problems due its institutional arrangements. The concept of legitimacy in social sciences is indivisible from the work of the sociologist Weber who defined the term as "the phenomenon that people are willing to accept domination on normative grounds" (Steffek 2000 p. 5). It is the acceptance of a government as an authority. According to Franck (1988), the legitimacy of a ruler derives from the perception of the governed that the former has come to power through a fair process. For his part, Steffek emphasizes the requirement of justice in the outcomes.¹¹ Skogstad amalgamates these two dimensions by introducing the distinction between input and output legitimacy (Skogstad 2002).

¹¹ Justice here is defined as the Rawlsian approach to distributive justice, notably 'justice as fairness' (Rawls, 1971).

On the one hand, the ‘output’ legitimacy of a system defines its capacity to achieve the goals defined in its mandate and to solve citizens’ problems (Horeth 1999). In most cases these results are difficult to appreciate, implying that ‘output’ legitimacy can only address a narrow range of policy domains (Skogstad 2003). For instance, technocratic delegation within the EU (to the Commission or the European Central Bank) is viewed as legitimate if and to the extent that power is delegated to independent actors who have no incentive to do other than deliver the EU goals (as defined by the polity) with maximum efficiency.

On the other hand, the ‘input’ legitimacy raises the question of the process by which authorities have come to power that is acceptable to the polity. The most common form of input legitimacy is the democratic election of representatives. Majone states that this form of legitimacy cannot be transferred from politically accountable principals to non-majoritarian institutions.¹² Yet he adds that legitimacy can be considered as ‘indirect’ if it is subject to some substantive and procedural criteria, such as reporting obligation or the establishment of controls of the agent’s work (Majone 1999).

The source of legitimacy plays an important role in the aid architecture too, providing important insights into the operational existence of bilateral and multilateral development actors. As it stands, the global aid architecture is often criticised for an apparent lack of output and input legitimacy (Najam 2002). For instance, while bilateral institutions are generally more accountable to national parliaments,¹³ the output legitimacy of bilateral institutions invariably suffers from direct political pressures and national interests, reflected in inefficient practices such as tied aid (Barder et al 2010). Conversely, while some multilateral institutions are deemed to be efficient, they face problems of input legitimacy and trust because they are democratically unaccountable and dominated by G-7 countries (Lele, Sadik, and Simmons 2006). Consequently Barder et al (2010) maintain that in some aspects of aid governance there is a common trade-off between accountability and effectiveness. To give an example, while the DAC is recognized for its competent work in the area of statistics and reporting, it essentially remains a rich country club and, in part as a consequence, is more effective at keeping score than driving change.

¹²For instance, national development banks and multilateral institutions such as the World Bank and European Commission.

¹³Either via the democratic elections by which national development ministries are appointed or via indirect legitimacy and accountability of national development banks to national parliaments.

Empirically, however, Barder's notion is not always true. Indeed, some of the major specialized UN organizations such as World Health Organization (WHO), the Food and Agriculture Organization (FAO), and programs such as the United Nations Development Program (UNDP), enjoy indirect input legitimacy but their effectiveness is often questioned (DfID 2011). In addition, there has been a growing concern surrounding fiduciary responsibilities in development finance of late. One example is the European Court of Auditors criticism regarding Commission-managed budget support programs (EPHA 2009). Consequently it would be an oversimplification to analyse the traditional aid architecture along the lines of bilateral and multilateral sources of legitimacy. With the exception of the direct democratic legitimacy that nationally elected development ministries enjoy, both bilateral and multilateral institutions involve elements of delegated authority. While some represent classical agency relationship, others act in almost total independence (Majone 2001). The key question here is the way in which authority is delegated. Indeed, transferring power from a democratically elected government (as is the case with most donor countries) to a non-majoritarian entity (i.e. bilateral or multilateral) has to do with the expected outcomes of such an operation.

According to Majone, there are 'two logics of delegation'. These logics differ in terms of the benefits researched by the delegating entity and lead to particular forms of relationship between the two bodies (Majone 2001). When the purpose of the delegation is mainly led by cost-reducing concerns, Majone refers to a principal-agent relationship. The main concern of the principal will be in that case to limit the agent's autonomy by designing an adequate institutional framework with a balanced system of incentives and controls (ibid). The fiduciary relationship is an extreme case of the agency relationship theory. According to Majone:

A fiduciary relationship exists where one person (the trustee) is obliged, or has undertaken, to act in relation to a particular matter in the interests of another and is entrusted with a power to affect those interests in a legal and practical sense, and where there is a special vulnerability of those whose interests are entrusted to the power of another. (Majone 2001 p. 5)

It implies a total commitment of the agent – called the ‘trustee’ – to the goals of its principal – the ‘beneficiary’. All delegation of authority (that is, every principle-agent relationship) potentially invokes legitimacy issues.

Consequently, various sources of legitimacy coexist, from the democratic legitimacy of parliaments to the indirect legitimacy of the World Bank or IMF, as well as hybrid cases. The European Commission, for instance, is deemed a hybrid case. The source of its legitimacy varies depending on the task it is completing. In areas where its power is delegated by the Council and controls are conducted by the ‘comitology committees’,¹⁴ the Commission can be considered as an agent of the Council. When it exercises its monopoly of initiative and enjoys its independence derived from the Treaties, the Commission can be viewed as the European Parliament’s and Council’s ‘trustee’ (Majone 2001). This is the case for the European Commission’s development policy, with the Directorate General for Development and Cooperation (DEVCO) operating as a largely independent body.¹⁵ While the output legitimacy of the EC is rather streamlined, there is an unambiguous lack of direct democratic legitimacy in the European Commission’s development practices (DfID 2011).

Other bilateral and multilateral institutions face a similar set up: efficient in its results, however invariably lacking input legitimacy. This is particularly true for bilateral institutions such as the German *Gesellschaft fuer Internationale Zusammenarbeit* (GIZ) and multilateral ones such as the World Bank or IMF. However, contrary to Majone, Longo (2004) holds that even if the concept of ‘legitimacy’ tends to take place in terms of democracy (i.e. via the democratic election of representatives) some decisions taken by non-elected bodies are still deemed as legitimate. This is the case when populations and governments accept to be regulated by a non-democratic institution as long as it respects its founding treaty, is controlled by a system of checks and balances, is successful in providing its outcomes, and complies with the rules of democratic accountability.

¹⁴The EU’s Comitology Committees oversee the delegated acts, which are implemented by the European Commission.

¹⁵EU development assistance is disbursed via multi-annual programmes which are coordinated by the European Commission’s Directorate-General (DG) Development and Cooperation (DEVCO). Since June 2011 the old Development and Aid Cooperation DGs were merged into the new DEVCO/EuropeAid, and DG External Relations (RELEX) for the rest of the world. DEVCO is responsible for policy formulation at a global and sectoral scale, formulating development policy applicable to all developing countries, conducts forward looking studies to this end, and implements the programs funded under the budget. Finally, the Council plays an important role in approving allocations and strategies.

Hence whether democratic accountability and political independence may in fact be reconciled depends critically on the way in which non-majoritarian institutions, electorally accountable principals, and the general public are organized. Furthermore, because universal challenges are increasingly cutting across national, sector and donor agency boundaries, a more integrated view needs to consider the legitimizing elements that non-traditional, that is innovative fundraising and financial solutions bring to the table. As will be discussed in the next chapter, new donor partnerships as well as new development actors, such as the Bill and Melinda Gates Foundation, not only contribute substantial finance and convening power, they may also enhance the input legitimacy of development aid by increasingly involving recipient country institutions as well as civil society via multi stakeholder governance systems.

1.33 Selective Incentives: Overcoming Collective Action Problems

Ultimately this thesis seeks to go beyond the application of the collective action theory on the traditional aid architecture, examining whether and how excessive turf fighting, administrative costs, and legitimacy problems can be addressed by the pursuit of innovative finance mechanisms for development. According to North (1991), the increase in transaction costs in the provision of a collective action necessitates institutions that reduce the risks of being cheated, either by raising the benefits of cooperative solutions or the costs of defection. Indeed, just as North, Olson (1965) previously argued that individuals in a group need selective incentive to overcome collective action problems. According to Olson:

Only a separate and “selective” incentive will stimulate a rational individual in a group to act in a group oriented way. In such circumstances group action can be obtained only through an incentive that operates, not indiscriminately, like the collective good, upon the group as a whole, but rather selectively toward the individuals in the group. (Olson 1965 p. 51).

A positive selective incentive is therefore any reward that leaves the individual part of the collective group on a higher indifference curve than previously. Steinwand (2012) used data on bilateral official development aid from 15 OECD donors and 96 recipient countries from

1973 to 2007 to explore if selective incentives can help to alleviate the negative welfare effects of free-riding losses that are common to developmental aid. According to this study, selective incentives can reduce free-riding losses in some cases. Consequently, Steinwand argues that:

The ability to satisfy self-interested goals provides donors with selective incentives to provide more developmental aid. This is because selective incentives reduce the marginal costs of providing aid of all forms. In an anarchic environment in which developmental aid is subject to collective action problems, this translates into higher equilibrium allocations for the donor who has the lowest marginal costs of providing developmental aid.
(Steinwand 2012 p. 2)

In building on the work of Steinwand, the thesis sets out to explore whether innovative financing modalities have the ability to increase the equilibrium allocations of aid delivery for donors by providing more value for money than traditional aid, thus increasing the benefits of cooperation, as well as raising the costs of defection. First, however, the following chapter will discuss the evolution of the aid effectiveness debate and provide an overview of the different aid modalities at the disposal of donor organisations.

2 The Evolution of Aid Effectiveness and the Choice of Aid Modalities

Development assistance is a constantly evolving field characterized by a multitude of approaches and aid modalities. Having outlined some of the collective action problems of the traditional aid architecture, the aim of this chapter is to provide an overview of the evolution of the aid effectiveness debate and to highlight some of the main drivers of change in donor aid strategies. This will provide the basis for the discussion surrounding the role of new aid modalities, and where they fit into the aid effectiveness evolution. Indeed, the current rethinking of aid modalities stems from past experiences with different modalities, changing priorities in donor countries, as well the emphasis on aid effectiveness and its role in development. With a view to understanding the relationship between aid, economic growth and poverty, this chapter will thus set out by looking at the research literature on aid effectiveness. The emerging consensus of this literature review suggests that aid can have a positive impact on growth and poverty alleviation, but that there are a multitude of factors which drive the evolution of aid modalities. Ultimately it finds that there is a potential to pursue new aid modalities to increase the harmonisation and coordination of aid, as well as to increasingly leverage private finance to enhance the effectiveness of donor assistance.

2.1 Origins of Aid Debate and Project Aid: 1950s – 1980s

The origin of modern development assistance has to be seen in the context of Post-World War II and the Cold War. Launched after the war in 1948, the U.S. funded Marshall Plan was a large-scale aid project which sought to strengthen links with Western European countries, creating market based democracies, and containing Soviet influence in the region. Soon thereafter a wave of decolonisation swept across the world. Notions of a ‘developed’ and ‘developing world’ emerged given marked differences in the levels of industrialisation between former colonial countries and the newly independent states. Colonial countries sought to maintain their sphere of influence in former colonies via economic and political

relations. At the same time international institutions created to support post-war European reconstruction shifted their focus to developing countries.

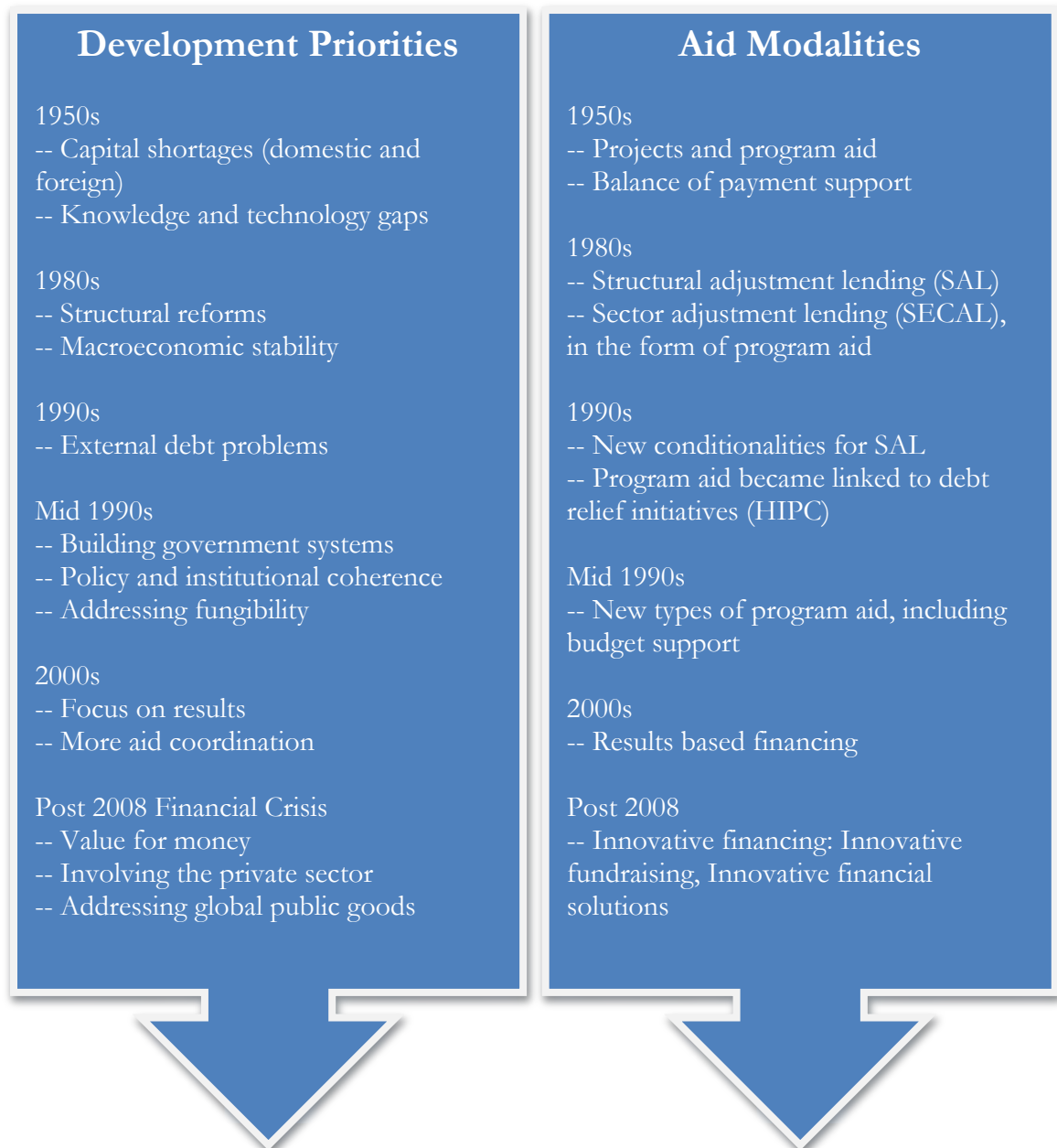
Development aid became both a foreign policy tool as well as a way of supporting industrialisation in developing countries. The early literature on aid was thus strongly influenced by the experiences of post war European reconstruction projects such as the U.S. funded Marshall Plan. The general view that the early growth models supported was that aid has the ability to foster economic development by relaxing savings and foreign-exchange constraints, thereby allowing for capital formation and economic growth (Papanek 1972; Chenery and Strout 1966; Meier and Stiglitz 2001). According to these theories, capital scarcity was regarded as a key impediment to economic growth. Accordingly ODA was seen as a tool to escape economic stagnation and poverty by allowing for the necessary investments that would permit recipient countries to create a virtuous circle of productivity and growth.

In line with these theories, it was believed that by simply calculating the financing gap required for targeted economic growth, donors could subsequently fill it with aid (Meier and Stiglitz 2001). Consequently a number of growth models were developed which came to be known as ‘gap theories’, the most well known of which was the Harrod-Domar growth model (Harrod 1948; Domar 1947). According to Harrod-Domar, filling the savings gap in developing countries with foreign aid was crucial for investment and fostering economic growth.¹⁶

Based on this prevailing view, the “gap theories” prompted development agencies to provide credits and grants predominantly in the form of project aid (see Figure 2.1). Financed by the governments of donor countries and multilateral development agencies, project aid is a form of aid to finance specific activities with a limited objective, budget and timeframe to achieve specific results. Here donors identify a specific area of intervention for their involvement, and subsequently direct their funds for these activities. In line with the theory, the underlying assumption was that by financing projects such as roads, hospitals, or schools, donor agencies would free up savings in these countries, allowing for more investments and domestic financing to push economic growth.

¹⁶Additionally, Chenery and Strout (1966) recognised a foreign exchange gap, and Bacha (1990) and Taylor (1990) highlighted the role aid could play in relieving fiscal gaps in recipient countries.

Figure 2.1: Evolution of Aid Debate and Aid Modalities



Source: Bourguignon and Sundberg (2007) and author.

While development policy was significantly influenced by the gap theories, the on going Cold War saw dramatic shifts in economic, political and moral allegiances. Though donor agencies were pushing for catch up growth in developing countries, a large portion of aid was given out of commercial and strategic motivations (Boone 1996). Moreover, following the second wave of decolonisation in 1960s, foreign aid became dominated by bilateral aid

programs (Hjertholm et al 2000). Much of this aid was tied aid, requiring the recipient to spend a proportion of the aid given on goods and services produced by the donor nation (Gillies 1986).

Within this context a number of empirical studies in the 1970's found that while aid was flowing in to close the anticipated 'capital bottlenecks', economic growth did not follow suit (White 1992). Consequently these studies suggested that aid had either been displaced or had no impact on domestic savings. These results generated significant controversy and divided the lines of thinking into two opposing schools of thought: one which believed aid had an impact and another that believed it did not (Papanek 1972; Papanek 1973; Mosley, Hudson, and Horrell 1987).

2.2 Structural Adjustment Programs: 1980s

Part of the problem with the confusion surrounding the early research on aid was the overwhelming optimism of the gap theories with regard to aid effectiveness. Papanek (1972) branded the highly optimistic approach of these growth models as "curiously naïve". In a subsequent paper Papanek (1973) argued that the focus in the aid-effectiveness debate should shift away from the aid savings relationship to examining the effects of aid on the various elements of investment and growth. Simultaneously donors started moving away from their modus operandi of project aid at the micro level. This was brought about by three factors. First, project aid was constrained in terms of "scalability", meaning that what worked in one environment did not necessarily work in another, making it hard to replicate development outcomes. Second, the grants and loans transferred were essentially "fungible", meaning that they could be used by the recipient government for purposes other than what they were meant for. Third, donors increasingly lamented the poor quality of the overall policy environment in the recipient countries as an obstacle (Ohno and Niiya 2004).

While donors found the issue of scalability hard to overcome, they attempted to address the issues of fungibility and poor policy environment with the tool of aid conditionality for qualifying loans and grants. Consequently in the 1980s, large donor institutions such as the World Bank and the IMF endorsed 'structural adjustment' lending, with the objective of guiding developing countries towards economic development by adjusting their economic

policies and structures. These institutions argued that aid had not worked over the last three decades given the unfavourable economic policies in the recipient countries. Consequently there was a need to attach conditionalities to aid with a view to extracting the desired policy changes, ultimately allowing for growth and development (Ohno et al 2004).

Structural adjustment, however, was also driven by balance of payment and debt problems in donor countries in the 1980s. Consequently Hjertholm et al (2000) argue that the emergence of adjustment lending was not a response to a development crisis, but rather a response to the imminent risk of financial crisis in developed countries. The subsequent focus on macroeconomic policy gave the World Bank and the IMF a central role in driving their policy agenda, henceforth referred to as the 'Washington Consensus'.

Conditioning aid in return for explicit negotiated commitments to reform meant that policy change was the price that recipient governments, in effect, paid in exchange for aid. Moreover, with the introduction of structural adjustment operations, the use of project aid decreased substantially while the share of program aid increased drastically. The share of project aid given by the World Bank declined from 82% to 48% during 1980-1996, while that of program aid rose from 2% to 23% over the same period (Mosley and Eeckhout 2000 p. 132). However, while the World Bank and the IMF were drastically pushing this new aid modality, empirical research on the macroeconomic effects of aid remained ambiguous, as did the views expressed in the aid literature with regard to its effect on growth and development (Mosley et al 1987). Whereas many micro or project related studies found a positive impact of aid, most macro related studies found no clear evidence regarding the impact of aid on growth. This prompted Mosley et al (1987) coin the oft-cited term 'micro-macro paradox' of aid.

By the early 1990s the general consensus in the aid literature was that program aid released on the promise of policy change backed by the threat of withholding aid was ineffective. Even the World Bank recognized that structural adjustment did not bring about the growth it predicted (World Bank 1990, World Bank 1992). In hindsight, problems with failed policy conditionality are unsurprising. Donors and agencies presumed that heavy-handed conditionality on a set of policies would 'make development happen'. In reality, however, this approach severely undermined ownership of national development efforts. According to Collier, Guillaumont, and Guillaumont (1997), if donors "bought" reforms via program aid, they become the owners. This created incentive problems for the recipient

government to fully commit to an externally imposed development strategy. Indeed in many recipient countries the reaction was one of rejection rather than acceptance of the conditionalities (World Bank 2005). What is more, in several cases the pace and depth at which structural adjustment policies were pushed through did more harm than good (Herbst 1990; Cornia and Helleiner 1994). The general objective of these policies was to reduce the recipient country's fiscal imbalances in the short and medium term to adjust the economies to long-term growth. However the heavy cuts in social expenditure programs that were often a part of structural adjustment led to social unrest and political instability and did not unleash the economic growth it had promised. Ultimately this cemented the consensus that structural adjustment aid had been a failure and that a new approach to aid effectiveness was necessary.

2.3 New Conditionalities, Ownership and Budget Support: 1990s

The policy failure of structural adjustment lending in recipient countries in the 1980s led to significant changes in aid delivery in the 1990s. Indeed a number of new trends emerged. Initially the failure of structural adjustment programs led to a change in conditionality in the early 1990s. Donor institutions recognised that they would have to switch from “buying” a predefined set of policies on an ex ante basis, to an ex post conditionality based on a periodic assessment of government achievements (Collier et al 1997).

The early 1990s also brought about the end of the Soviet Union and thus the end of the Cold War. Eastern European countries shifted from being aid donors to new recipients. Aid levels began to drop as donors were moving away from supporting ‘friendly regimes’ to focusing on governance (Hjertholm et al 2000). New interests and obligations as a result of the geopolitical reshuffling meant that recipients now had to compete for the financial resources of industrialised countries.

By the mid 1990s, new studies in the aid literature and past experiences of donor agencies led to a number of profound shifts in aid modalities. First, donors moved from ‘stand-alone’ projects to project ‘clustering,’ often in the form of pooling funds under sector development programs. According to Ohno et al (2004), stand-alone projects had largely fallen out of favour due to coordination problems, high transaction costs of aid delivery, under budgeting for re-current expenditures, and off-budget systems undermining the

effectiveness of government systems and accountability. Consequently, under the new sector programs major donors provided support within an agreed sector framework, coordinated by the recipient government.

The second shift was from structural adjustment operations to General Budget Support (GBS). The EU defines budget support as “the transfer of financial resources of an external financing agency to the national treasury of a recipient country, following the respect by the latter of agreed conditions for payment” (EC 2008b p. 10).¹⁷ The monetary resources obtained are thus part of the global resources of the recipient country and consequentially used in line with the public financial management rules of that recipient country. Not only does this increase the partner countries’ resources, it also allows for budgetary implementation according to its own procedures.

Boone (1996) was instrumental in setting off the aid-effectiveness debate that contributed to this shift. Using panel data of 91 countries between 1971-1990, Boone demonstrated that instead of increasing investments benefitting the poor, foreign aid had led to rise in government consumption. Consequently a series of studies found that aid effectiveness critically depends on the institutions and policies of recipient countries (World Bank 1998). In the years that followed, a newfound optimism emerged in the aid literature. The ensuing narrative was one which emphasized that aid works, but only if policies were right, highlighting the role of local institutions, selectivity, and ownership. For their part, Burnside and Dollar (2000) found that while aid had little effect on countries with poor policies, its impact on growth in countries with healthy monetary, fiscal, and trade policies was positive. Not only did this represent a fundamental change in the aid debate, but these findings also helped address the “micro-macro paradox”, explaining why aid can be effective at the project level, while leaving no impact at the macro level (Robinson and Tarp 2000).

In terms of donor policy, structural adjustment was thus seen to increasingly isolate aid efforts from local realities, undermining local ownership and capacity, and ultimately obstructing development progress. The subsequent shift was therefore an effort to overcome the weaknesses of structural adjustment programs, moving towards more

¹⁷There are variations of budget support, such as general budget support and sector budget support. While both represent a transfer to the national treasury of a partner country, the former supports a national development or reform strategy and the latter supports a sector policy or strategy. Contrary to general budget support, sector budget support typically concerns one particular sector, and can address in a more focused manner the specific needs of this particular sector or reform. These different objectives are consequently reflected in the conditions and negotiations between the Commission and its partner countries.

progressive aid modalities in the form of budget support and sector development programs. Nonetheless, questions remained in the aid literature and among policymakers about the quality, value for money, impact and fiduciary risk of budget support (Ohno et al 2004). Often considered the “gold standard” of aid modalities, budget support is also the most demanding for both partner countries and donors alike and is highly contested in parliaments of donor countries. What is more, for donor agencies the impact of budget support is difficult to measure and it creates inherent contradictions between the incentives that agencies face in promoting ownership by recipients and the incentives they face in retaining control of their development interventions (Ohno et al 2004). These concerns together with a shift in the aid effectiveness literature prompted an entirely new development agenda to emerge at the turn of the millennium.

2.4 Results Based Financing and the Paris Declaration on Aid Effectiveness: 2000s

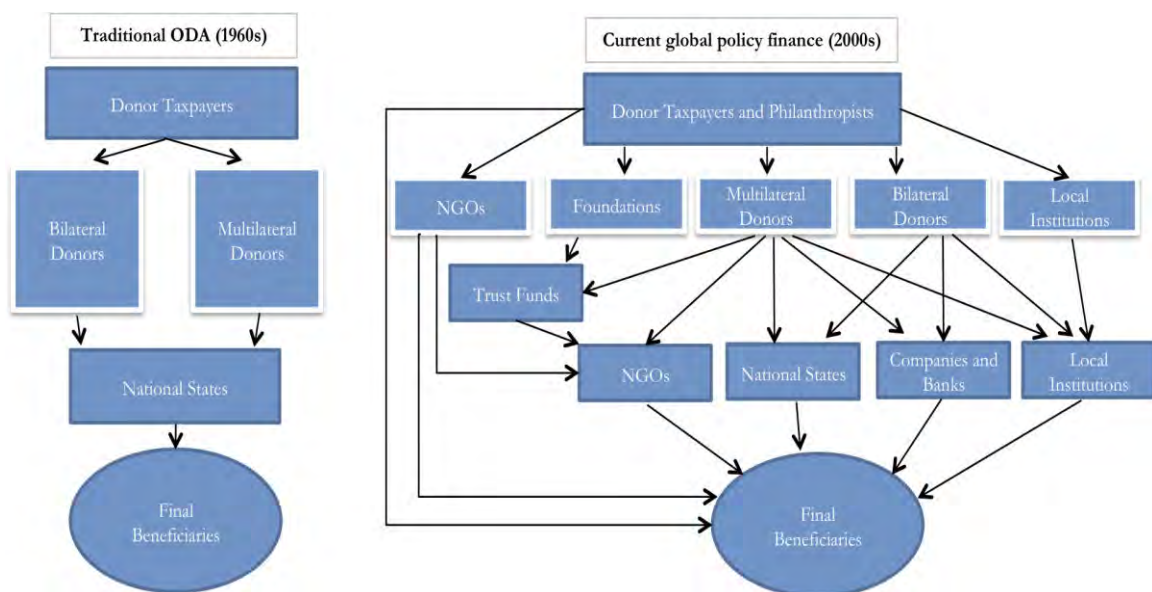
The ambiguity regarding the impact of aid on growth and poverty alleviation in the 1980s and the end of the Cold War in the early 1990s led donors to scale down the volume of their commitments. However in the year 2000 a global event brought about a significant reversal of this trend. Riding on the wave of strong economic growth throughout the 1990s, the Millennium Development Goals saw world leaders agreed to a new set of development targets and commitments. The MDGs comprised a common set of development goals to be achieved by the year of 2015. According to Amprou and Guillaumont (2007), the aid debate subsequently became dominated by the ‘big push’ thesis. As part of his work for the United Nations Millennium Project, Sachs (2005) became the key advocate of this approach, emphasizing the need to scale up aid commitments to fill the financing gap to achieve the MDGs.

Sachs’ campaign became instrumental to the renewed level of commitment of donors to scale up aid. Following the Millennium Summit in 2000, the first international conference on financing for development was held in Monterrey, Mexico, in 2002. The Monterrey Consensus was a milestone in development policy. Between 2002 and 2006, Monterrey

spawned increased ODA commitments, new initiatives in Gleneagles and Barcelona, debt relief, and the Paris Declaration on Aid Effectiveness.

The momentum created by these events set off a number of fundamental changes in the aid architecture. Most notably, two main features have begun to take shape (Bourguignon et al 2007). First, one line of research on aid effectiveness increasingly emphasized the need for more alignment and harmonization of aid, as the MDG campaign contributed to a rapidly growing institutional aid architecture (see Figure 2.2). Since the advent of international development assistance, resources had predominantly been channelled from donor states to recipient governments through bilateral aid programs. A portion of these resources were pooled between donor countries, and delivered via a few multilateral organisations. Since the early 2000s, however, a large variety of public, private and hybrid actors have come on the scene, each delivering a growing variety of public goods.

Figure 2.2: International Development Assistance Then and Now



Source: Severino and Ray (2009) and author.

The fragmentation of aid efforts led to a surge in compliance costs for recipient governments and increased aid volatility. Balogun (2005) argued that aid harmonisation between donors needs to be considered a major requisite for aid effectiveness, reducing transaction costs and increasing efficiency of aid delivery for donors and recipients alike.

According to Bigsten (2006), the cost of aid delivery in particular had become a hot topic. Moreover, Bourguignon et al (2007) emphasized that:

Aid flows are more volatile than public revenues, which, with imperfect credit markets, undermine long-term investment planning. The need to improve aid quality and redesign delivery systems to improve aid 'harmonization and alignment' is now widely recognized. (Bourguignon et al 2007 p. 7)¹⁸

Against this backdrop the harmonization of procedures came to the forefront of the aid debate. In order to ensure the maximum impact of aid, policymakers and academics highlighted the need for donor efforts to be aligned and harmonized. Consequently, the 2005 Paris Declaration on Aid Effectiveness saw over one hundred ministers, heads of development agencies and other senior officials commit their countries and organizations to increasing efforts on aid effectiveness. The outcome included the commitment to twelve indicators of progress on ownership, alignment, harmonisation, managing for results, and mutual accountability.¹⁹ This included commitments to harmonise ODA, adapt it better to the recipient country's development strategy, reduce transaction costs and bureaucratic procedures, untie aid, as well as grant ODA increasingly as direct budget support.²⁰

Almost a decade after the formulation of the twelve indicators, progress on the Paris Declaration has been subject to considerable criticism by academics and policymakers. Not only has progress been slow, however, the lack of compliance mechanisms meant that policy goals could be overruled by organisational goals of donor institutions. What is more, Lackert (2009) believes that commercial interests of donor countries have prevented donors from fully implementing the Paris principles. Finally, the original methodology has also been subject to criticism. A recent UNDP (2014) press release argues that the targets look more at the bureaucratic process of aid rather than the actual impact it has on reducing poverty.

¹⁸ With regard to aid volatility, Lensink and Morrissey (2000) examine the relationship between volatile aid and aid effectiveness. According to their study, aid can contribute to higher growth, however aid effectiveness is adversely affected by volatile aid flows.

¹⁹ See Part II of the Paris Declaration on Aid Effectiveness (OECD 2005).

²⁰ A follow-up conference to the Paris Declaration was held in Accra, Ghana, in September 2008, vowing to adopt further steps to improve the quality of ODA.

The second feature which began to take shape following the Millennium Summit in 2000 was that donors began putting an increasing emphasis on allocation of ‘performance based aid’. Due to the disillusionment with policy conditionality of previous aid modalities, donors sought a new form of performance based (or outcome-based) conditionality. Consequently aid was tied to pre-defined performance indicators which aimed to address numerous aspects of development effectiveness. The idea was to make aid dependent on measurable development outcomes such as child mortality, poverty reduction, and literacy rates, as well as on the discernible quality of development policies. This approach promised to avoid many of the pitfalls of policy conditionality and was consistent with the desire for development assistance to show results in the lead up to the 2015 MDG targets. In keeping with the Paris principles of aid effectiveness, aid was increasingly aligned with country performance targets, thus promoting ownership and aid predictability. Furthermore, more aid was channelled via budget support rather than tying it to specific projects or policies.

Yet performance based aid modalities come with their own set of potential problems (Bourguignon et al 2007). First, both recipients and donors face a time consistency problem. If the targets are defined over too short of a period, then successful projects may be seen as a failure. What is more, aid volatility and unpredictability make long run planning of public expenditure a daunting task. This is particularly true for interventions that require recurrent expenditures (i.e. health and education). Conversely if the targets are defined over too long a period, then the recipient government may not be inclined to perform well, given the lack of incentive to do so. Second, deciding how to balance the allocation of aid on a performance basis or needs basis is a problem. While rewarding good performance provides the right kind of incentives to recipients, it could potentially lead to a situation in which a limited number of countries which are already doing well receive the assistance. On the other hand addressing the greatest need would use donor assistance in countries with corrupt and poor policy environments, most probably rendering it ineffective. Therefore Bourguignon et al argue that while a balance is necessary, “incentive constraints may impose limits on redistribution towards the poorest” (Bourguignon et al 2007 p. 10).

2.5 Growing Dichotomy in Aid Debate and Innovative Financing for Development: Current Aid Architecture

The current aid landscape has seen traditional development aid come under increasing pressure. In the wake of the recent financial crisis, donor countries have seen renewed fiscal pressures which may have long-term effects on their ability and willingness to provide aid (Dang, Knack, and Rogers 2009). Simultaneously the aid effectiveness debate remains contentious. Since the inception of development assistance in the 1950s the focus has been on whether more aid leads to better outcomes, particularly in terms of higher growth. Yet in a meta-analysis survey of 97 different studies in the literature, Bourguignon (2007) finds that the impact of aid on growth appears to be small, if not insignificant.

Given the multi-dimensionality of development objectives and the trouble of measuring the counterfactual of aid (i.e. no aid), opinions remain divided. Hence, while Easterly (2006) holds that aid has had no impact on growth for its largest recipient, Africa, Collier (2006) believes that growth would have been far worse in the absence of aid. Consequently there has been a growing dichotomy in the current aid architecture regarding the role of aid in development and growth. Severino and Ray (2009) argue that traditional ODA is an outdated concept which is not suited to the current metamorphosis of the development cooperation landscape. Even more radically, Moyo (2009) presents her book as the story of the failure of post-war development policy, and proposes an alternative in the form of aid-free market-based solutions to development problems. She strongly criticises the current aid-based approach, highlighting the vicious cycle of corruption, market distortions and poverty it has fuelled in aid-dependent countries. Moyo believes that in order to succeed and escape the mire of poverty and despair, African countries need to put an end to their aid dependency, shifting to an alternative strategy.

Conversely, Riddell (2007) argues the fundamental question in the current aid discourse is not 'Does aid work?', but much rather 'How can aid be made more effective?'. He goes on to argue that if enhancing the effectiveness of aid were to become the principal question in the aid discourse, then the justification for providing development aid will be considerably enhanced if its effectiveness is improved. In analysing the current architecture, Riddell classifies three categories of problems with aid caused by donors. First, distortions caused by the political, strategic and commercial interests of donors. Second, aid volumes, volatility and

voluntarism in the provision of aid, and third, the multiplicity of donors and aid funds programs and projects. On the recipient end he identifies problems of commitment, capacity, ownership and governance.

While the literature generally agrees that there is a need to increase the effectiveness of aid and restructure aid delivery mechanisms to improve aid harmonization and alignment, it seems highly unlikely that traditional aid channels will be able to do so. A number of studies highlight that foreign aid is focused heavily on a few countries, highly fragmented and volatile, inconsistent with other policy areas, and suffers from legitimacy concerns (OECD 2008; Lele et al 2006; Barder 2010). Furthermore, as outlined above, Bourguignon et al (2007) and Riddell (2007) argue that both donors and recipients suffer from high negotiation and transaction. For donors this implies time and resources spent in reaching compromises, while for recipients it entails coping with an increasingly complex and challenging system.

In the wake of the financial crisis and the global economic recession, aid needs to play an important countercyclical role, ensuring that financial flows to developing countries are somewhat balanced. Indeed ODA and FDI have successfully provided countercyclical financing during previous financial crises.²¹ Yet Bulir and Hamann (2005) find that aid is pro-cyclical with both donor and recipient incomes and conclude that rather than cushioning economic shocks, aid often represents another element of instability.²²

Driven by poor economic growth and resource shortages in donor countries, the period following the 2008 financial crisis has thus seen a new focus in donor aid strategies: innovative financing for development. The concept of innovative finance and its current terminology is relatively recent. While certain mechanisms, such as a tax on international financial transactions, had been suggested as early as the 1970's, the broadly defined concept of innovative finance in the context of development coordination originated in the mid 1990s (United Nations 1995). Yet the emphasis on traditional ODA remained overwhelming. Only after the UN conference on Financing for Development in Monterrey (Mexico) in 2002 did donor governments first recognize the need for additional financial resources in the conference outcome document (United Nations 2002).

²¹One example is after the Mexican debt crisis in 1982. While commercial lending had substantially dropped for about a decade, aid flows had risen slightly over the same period, thereby playing an important countercyclical role and maintaining financial flows to Latin America.

²²This is consistent with the findings of the OECD (2012), who highlight that aid to developing countries dropped by 3% in 2011 largely as a result of the economic crisis in donor countries.

Following the Monterrey Conference, the development community set out to find ‘innovative’ or alternative sources of development finance with a view to furthering development efforts. Yet innovative financing as realistic policy tools only received significant attention following the financial crisis in 2008. In the wake of ballooning fiscal deficits in donor countries, sovereign and private donors started supporting a large variety of innovative initiatives with the aim of leveraging additional development finance. Development banks increasingly issued novel bonds that tie resource mobilisation to development objectives, while new foundations and private actors were entering the stage too (Maxwell 2013).²³

Simultaneously recipient countries have been changing too. Rapid economic growth in the developing world has transformed formerly poor countries such as Indonesia, China, and Brazil into Middle Income Countries (MICs).²⁴ While these countries have largely outgrown traditional aid, they are home to 72% of the world poorest people and face persistent social problems (Lalatta-Costerbosa, Schetelig, and Gomez 2013). Consequently MICs have been pursuing financial solutions that better meet their needs, i.e. risk mitigation efforts that promote private investment, partnerships that mobilize private money for public service delivery, as well as support for carbon trading (see Figure 2.3).

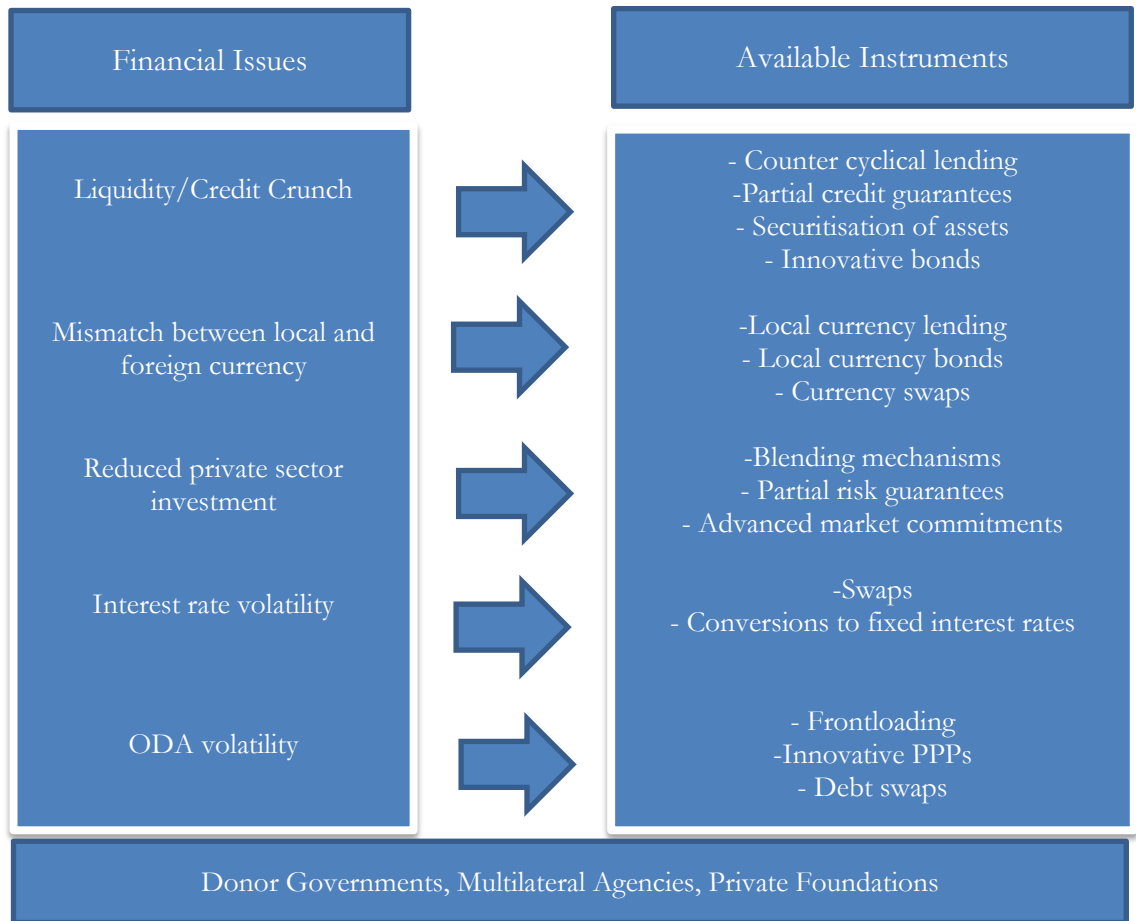
Certainly, on the whole, the emergence of new donors and creditors, both public and private, was a welcome development. Indeed, one of the positive aspects resulting from the emergence of new actors has been an increase in funding available for environmental and social protection arrangements in the event of exogenous shocks. What is more, the relative importance of private financial flows to developing countries has changed considerably in last thirty years, having grown substantially. The figures speak volumes. Alone between 1998 and 2010, net private flows to the developing world increased from US\$ 193.4 billion to US\$ 659 billion (United Nations 2010a p. 72). Yet as new options are being explored, questions regarding the value and complementarity of these modalities are being raised. Furthermore, it is unclear to what extent innovative aid modalities can be reconciled with the

²³Emerging donors are also becoming more active. Particularly China is becoming increasingly involved. In fact they provided more loans (predominantly in Africa) than the World Bank between 2008 and 2010. Furthermore, the Heritage Foundation estimated that about 14% of China’s investment abroad between 2005 and 2010 went to Sub-Saharan Africa (Scissors 2011).

²⁴Defined by the World Bank as countries whose annual per capita gross national income ranges from \$1,026 to \$12,475 (Lalatta-Costerbosa et al 2013).

aid effectiveness criteria as established by the Paris Declaration. It is within this context that the next chapter will introduce the role of innovative finance mechanisms for development.

Figure 2.3: Innovative Instruments Available



Source: World Bank (2009) and author.

3 Innovative Financing for Development

To many observers, the way development partners do business has undergone an important shift following the emergence of innovative financing mechanisms and vertical development funds. Here, however, a reality check may be in order. Indeed it is worth noting that the term ‘innovative financing’ has become a popular ‘catch-all’ phrase which should be used with caution. As will be discussed below, what exactly constitutes innovative financing is still poorly defined and could potentially be ‘old wine in new bottles’. Consequently some of these instruments may have existed for some time, but have simply grown in importance over the last years. Nonetheless, even if some of the instruments had been previously discussed, it is only now that their full potential is being considered. The aim of this chapter is thus to introduce the concept of innovative finance in general, and innovative blending in particular. Following a brief overview of the heterogeneous mix of innovative finance mechanisms that exist, the chapter will outline the evolution of catalytic aid and define the main drivers behind the emergence of innovative blending.

Ultimately the resurgence of catalytic aid in the form of blending mechanisms raises a key question: do these mechanisms actually provide more value for money for donor aid spent? Although preliminary analysis of blending mechanisms exists, more in depth empirical evaluation is necessary to determine their benefits and risks.

3.1 Defining Innovative Finance for Development

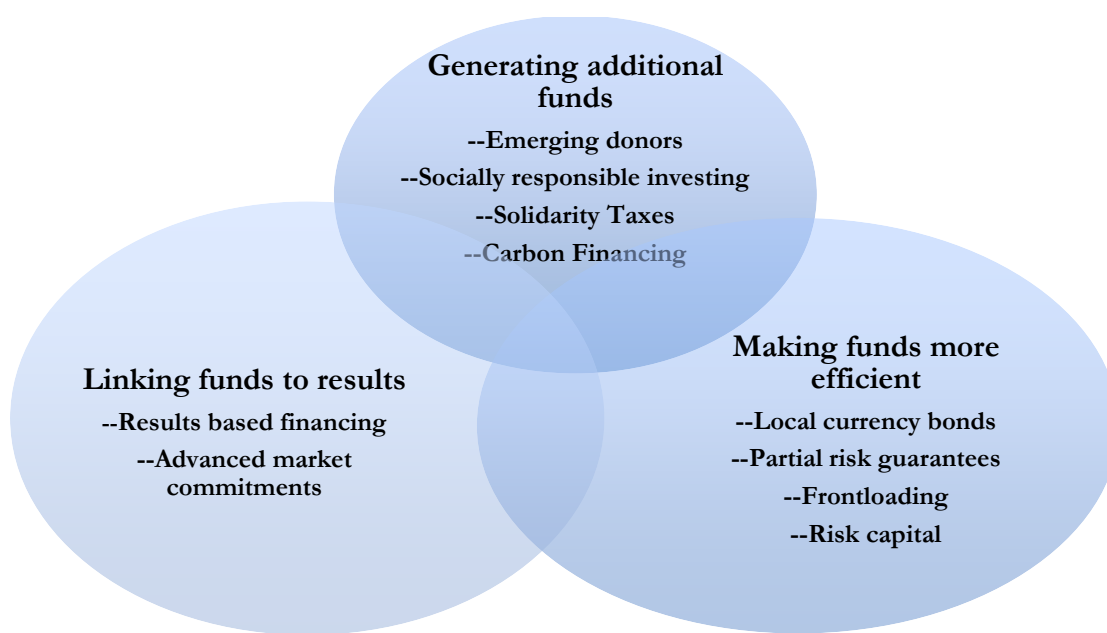
Given innovative financing only emerged as a credible policy tool in the last decade, there is still no consensus concerning its definition. Depending on whom one asks, innovative financing for development can mean different things. That being said, the World Bank (2009) has laid out a definition which defines innovative finance as any financing approach that helps to:

- i. Generate additional development funds by tapping new funding sources or by engaging new partners;

- ii. Enhance the efficiency of financial flows, by reducing delivery time and/or costs, especially for emergency needs and in crisis situations;
- iii. Make financial flows more results-oriented, by explicitly linking funding flows to measurable performance on the ground.

With a view to promoting a comprehensive understanding of innovative financing, this thesis adopts the World Bank's definition (see Figure 3.1 for examples).

Figure 3.1: Defining Innovative Development Financing



Source: World Bank (2009) and author.

As the definition above indicates, what makes these instruments innovative is not only financial originality in itself. What sets them apart is their departure from the traditional approach to development finance. First, in terms of mobilising, traditional aid is typically generated via budget disbursements from sovereign donors or the issuance of bonds by national and multilateral development banks exclusively. Innovative financing in contrast seeks to tap into new funding sources either from new levies or by engaging new partners for development. Potential contributors include citizens, corporations, equity funds, governments (in industrialised, emerging and developing countries), and multilateral institutions. However, in reality, even when new partners are involved, most aid still flows

through government channels as they have the capacities to implement meaningful development aid programs. Consequently new sources of financing should ideally complement, rather than substitute, government funding.

Second, in terms of channelling, most government aid is channelled via traditional aid channels such as project aid and budget support. This is often a cumbersome process characterised by a lack of coordination between stakeholders involved and a heavy handed donor approach in terms of implementation and oversight (Maxwell 2004). Innovative ways of channelling assistance may thus involve new forms of multi-stakeholder governance structures, increasing the efficiency of financial flows by reducing delivery time and/or costs. As noted by Lui, Byiers, and Steres:

In some cases the ‘innovative’ element in current thinking reveals itself most is in an apparent willingness to move largely beyond traditional conceptions of the different sources of development finance working largely in isolation from each other, to how they might be combined to greater effect. (Lui, Byiers, and Steres 2012 p. 9)

Third, in terms of targeting, donors could find powerful ways to unlock the value of their money by examining particular market inefficiencies of specific sectors that can benefit from development aid. Innovative solutions in this context surround ways to better target assistance to meet the needs of recipients. For instance, small and medium-size enterprises in developing economies are often underfunded because they typically are too small for commercial lending but too large for microcredit financing. There could be an opportunity for multiple players to collaborate in the creation of a set of financial instruments to target and serve this segment.

As will be outlined in a brief overview below, the World Bank (2009) goes on to distinguish between financial solutions on the ground and innovative fund-raising efforts. Here innovations offer a wide range of financial instruments, products and services via financial engineering efforts.²⁵

²⁵The selection of instruments by the donor community includes cash instruments (such as loans, grants, and securities), risk mitigation mechanisms (such as swaps, guarantees, loans and securities), conditional/results based instruments, as well as advisory services (World Bank 2009).

Finally, while some define innovative finance as being complementary to ODA (i.e. the Leading Group),²⁶ others advocating the ODA plus approach see it as a part of the wider ODA category. Yet there is still some confusion surrounding what the range of innovative financial resources mean in terms of recording flows. Within the OECD's recording of 'official' development flows, statistics now show a category for 'Other Official Flows' (OOF). These figures, which include non-concessional loans from bilateral and multilateral donors and fall outside the strict criteria for defining aid, already represent a significant source of development finance. That being said, this thesis advocates the emergence of mechanisms that can become a complementary form of assistance to traditional donor institutions and ultimately can be considered part of the wider ODA category. Nonetheless, whether innovative mechanisms can be classified as ODA depends on the instrument and ODA accounting guidelines in question.

3.2 What Options do Donors Have?

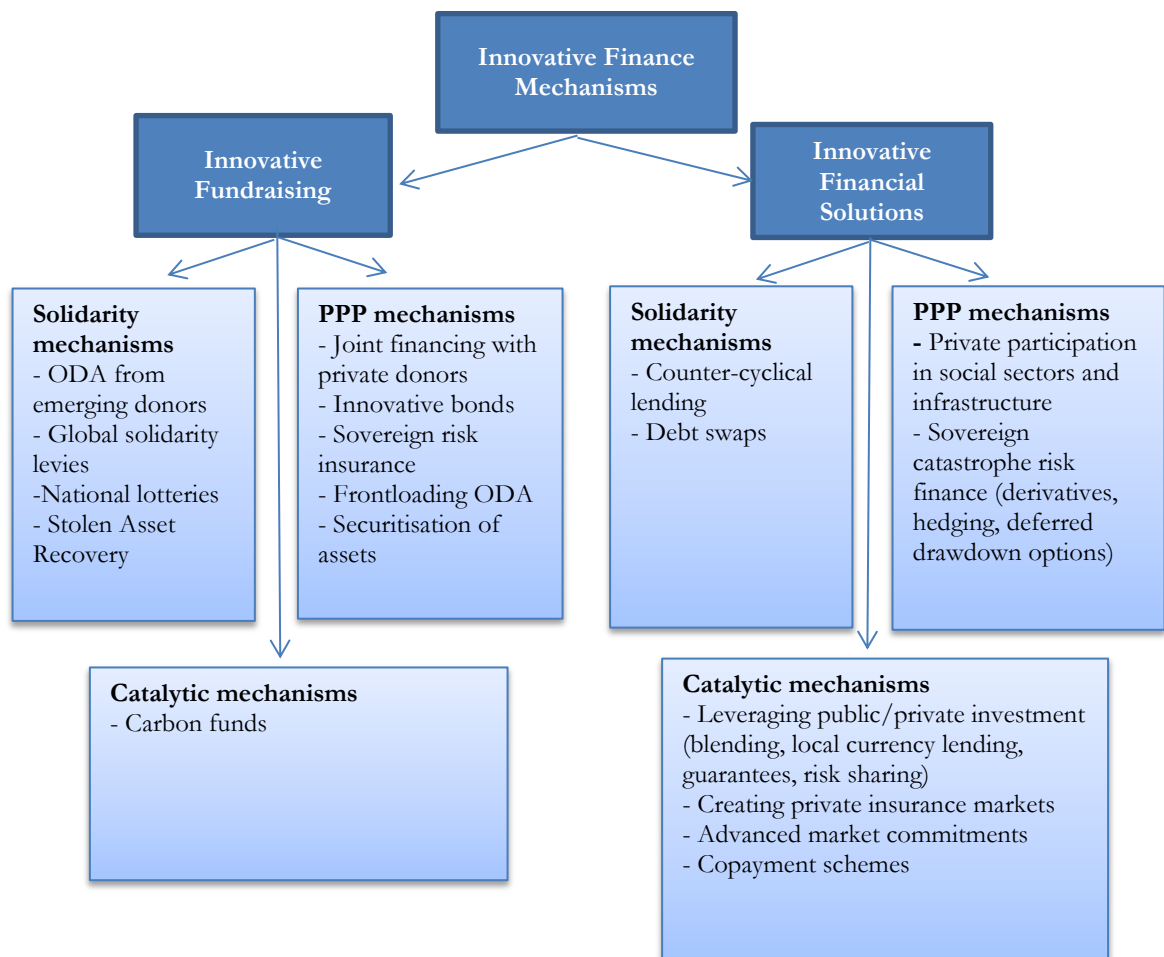
As was mentioned above, this thesis distinguishes between financial solutions on the ground and innovative fund-raising efforts. Within these, the international landscape is made up of broadly four types of innovative finance mechanisms: private, solidarity, public-private, and catalytic mechanisms (World Bank 2009). Of these four instruments, solidarity, public-private and catalytic mechanisms rely on official flows and/or regulatory arrangements undertaken by public authorities. These Innovative Finance Mechanisms (IFMs) are then employed to support global or country efforts via financial engineering (see Figure 3.2).

Here it is worth noting that not all of these innovative mechanisms are relevant to every context. Indeed, institutional development and depth of financial sectors are key in determining the feasibility of innovative fundraising and financial solutions. As outlined above, some MICs have established well functioning financial markets and financial institutions, allowing for donor organisations to work with established financial intermediaries. In theory this should allow for a broader range of aid delivery mechanisms

²⁶The Leading Group was created following the Paris Conference on Aid Effectiveness in 2005. It is a global inter-agency platform made up of 55 member countries, international organisations and NGOs. Coordinated by the French Foreign Ministry, the Leading Group seeks to promote the implementation and definition of innovative financing for development.

with a view to attracting foreign capital and driving productive investment projects. This is consistent with the work of Beck, Demirgüç-Kunt, and Levine (2004), and Honohan (2005), who have shown that countries with more complex and developed financial intermediaries experience faster declines in measures of poverty and income inequality, highlighting that the development of financial markets and institutions is helpful in reducing poverty. On the contrary, political economy theories of financial development highlight that in countries where a narrow elite controls the political processes, financial access and development will be obstructed (Girma, Greenaway, and Kneller 2004).

Figure 3.2: Sub-Sections of Innovative Finance Mechanisms



Source: World Bank (2009) and author.

While the aim of this thesis is not to review the various IFMs in use, nor to determine the institutional preconditions for each mechanism under proposal, Appendix B provides a comprehensive overview of innovative aid delivery mechanisms. Furthermore, in line with the delineation mentioned above, the following is an overview of the IFM landscape. First, private mechanisms are made up of private-to-private flows in civil society and the markets. Two examples of purely private fundraising initiatives include traditional philanthropy (voluntary contributions) and blended value investing (mixing profit maximising with philanthropic objectives). While philanthropy offers only a small tax return for the donor, private giving has generated considerable development sources over recent years, with estimates ranging from US\$17 billion from DAC donors in 2001 to US\$ 34 billion by the United States only in 2007 (Girishankar 2009 p. 82). Given these trends, it is suggested that charitable giving holds great potential to contribute to socially or environmentally beneficial causes in member countries of the OECD.²⁷

Second, solidarity mechanisms involve sovereign-to-sovereign transfers and represent the main pillar of bilateral and multilateral ODA. With a view to generating new solidarity funds, donors are increasingly looking to new global development levies. The idea behind global taxes is to allow for additional and predictable long-term funding to donor governments and institutions. Most global tax proposals are designed to produce a “double dividend”: generate added finance and, simultaneously, offset a global public bad. Over recent years a variety of global taxes have been suggested. This includes environmental taxes such as carbon and aviation taxes, as well as a Currency Transaction Tax (CTT). Further examples include charity lotteries, debt swaps, and counter-cyclical lending.

Third, public-private mechanisms mobilize or leverage private money for public service delivery as well as other government functions. Over the last 30 years there has been a vast increase in the range of options for Public-Private Partnerships (PPPs). PPPs for both new and existing services nowadays come in a variety of shapes and forms. These may range from service or management contracts, where a private company receives compensation for providing a public service, to privatization and outright sale of government assets to a private company. Another prevalent option is outsourcing, where a private company may be responsible for handling an aspect of the service. More recently, however, the emergence of

²⁷ In the United States of America it represents more than 1.5 per cent of national income (Technical Group 2004).

a wide variety of investors and operators in emerging markets with local expertise has prompted an explosive growth in the field of hybrid PPP models. Such models are frequently based on simple contractual agreements and generally blend private and public finance to spread risks. One example of an innovative PPP solution is Future Flow Securitization. Securitization of future receivables has the ability to improve a developing countries' access to international capital markets, using securitization of future-flows to raise significant bond financing. In theory such a transaction works on the basis of the borrower pledging future foreign-currency receivables as collateral to a special purpose vehicle (Ratha 2008). These future receivables may include remittances, oil, or airline ticket receivables. On the basis of a legal agreement between the borrower and correspondent customers and banks, this special purpose vehicle then issues the debt while the future receivables are directly deposited in an offshore collection account handled by a trustee. Ultimately the debt is serviced from this account, and any additional/surplus collections are channelled to the borrower.²⁸

Fourth, catalytic mechanisms aim to drive private sector development by providing public support, i.e. by reducing risks to private entry. One particularly relevant example is that of Advanced Market Commitments (AMCs). Advanced market commitments are innovative in the sense that they join market-based financing tools with public intervention. An AMC is essentially a multi-stakeholder agreement to guarantee a viable market for the development of a product that has social benefit, i.e. a vaccine or medicine. It works on the basis of a binding contract offered by a government or other financial actor. As such, AMCs tackle an enduring development problem: consistent private sector failure to research and develop products which are needed in developing countries owing to perceptions of insufficient demand and risk. AMCs may also promote multilateral policy coherence. By making use of the AMCs global governance body, the decision making process effectively circumvents national interest and lobbying powers, while simultaneously bringing together parties with opposing interests (pharmaceutical firms, donors, recipients, as well as Non Governmental Organisations). By promoting interest accommodation, this multi stakeholder

²⁸Further examples of innovative PPPs include indexed bonds, ODA frontloading, as well as sovereign catastrophe risk financing.

approach may strengthen multilateral coherence and help escape the usual agency competition logic.²⁹

Ultimately, while several innovations demonstrate potential, uncertainties remain about others. For example, intricate financial engineering and new governance structures could incur high costs which would directly offset the benefits that some mechanisms promise. Innovative fundraising initiatives should therefore be evaluated in terms of their capacity to generate suitable financing in a predictable manner at the minimum risk and cost. Furthermore, financial solutions on the ground should be analysed with regard to their ability to efficiently and effectively deliver development outcomes or targets.

3.3 Tailor Made Assistance: Innovative Blending Mechanisms

According to the UNDP's 2010 International Assessment on the MDG progress, the next years will serve as a test run for ideas that work, and those that do not (UNDP 2010). While there are many innovative mechanisms that show great potential, the benefits vary depending on the instrument in question and the context in which they are used. Furthermore, some mechanisms operate outside the sphere of sovereign donors, limiting the ability of traditional donors to adopt these instruments as complementary policy tools. Other mechanisms may also confront donor institutions with numerous challenges, i.e. fungibility of funds,³⁰ complex administrative set-ups, inter-temporal choice problems, as well as possible market distortions. Hence, rather than exploring the potential of each of the mechanisms under discussion, the aim of this thesis is to focus on one specific innovative financing modality: blending mechanisms.

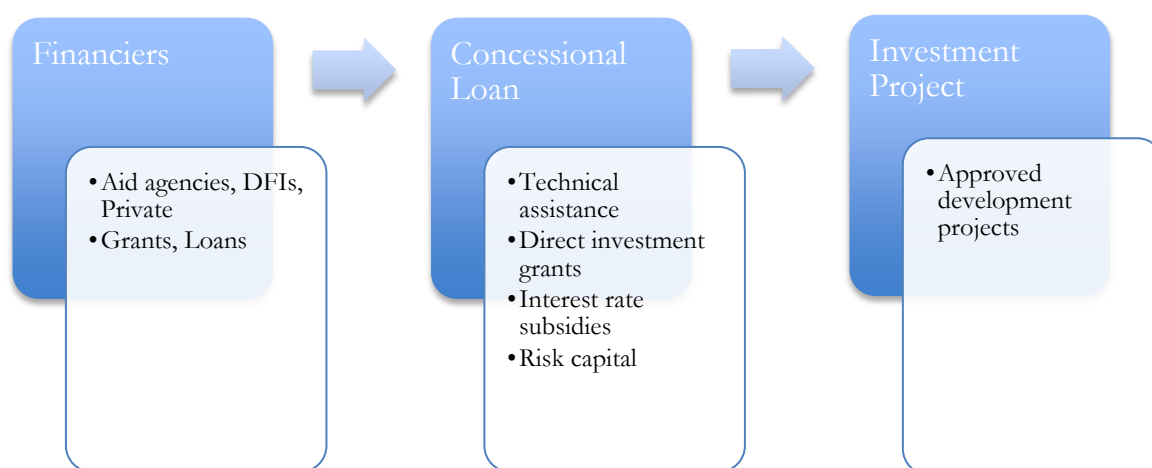
²⁹ Further examples of catalytic mechanisms include innovative patent solutions, as well as carbon funds and blending mechanisms.

³⁰ Funds that are not earmarked and can be redirected to non-developmental purpose.

3.31 Functioning and Scope: What is Blending?

Blending mechanisms refer to the practice of blending loans and grants to increase the volume and impact of development finance.³¹ Blending arrangements are essentially catalytic aid mechanisms allowing donor institutions to push their development objectives via new financing channels (see Figure 3.3).

Figure 3.3: Loan Grant Blending



Keeping in line with the World Bank definition of innovative development financing, Blending is in theory innovative in a number of ways. First, it aims to generate additional development funds by tapping new funding sources or by engaging new partners. As will be discussed in the empirical evaluation, these innovative structures should allow donors to offer a wide variety of financial instruments which would otherwise be pursued by donors or Development Finance Institutions (DFI) individually, or not at all. Second, blending seeks to enhance the efficiency of financial flows, by reducing delivery time and/or costs, especially for emergency needs and in crisis situations. And third, blending mechanisms seek to make financial flows more results-oriented by explicitly linking funding flows to measurable performance on the ground (Ferrer and Behrens 2011). Whether this is also true in practice will be analysed in detail by the empirical case study.

³¹Grants are transfers made in cash, goods or services for which no repayment from the recipient is required. Loans are transfers for which repayment of principal and interests by the recipient is required (ECDPM 2011).

Blending allows donors to push their development objectives via the private sector by making use of the multi-stakeholder governance structures which typically involve lending institutions and private investors. By combining donor grants with loans and channelling these via international or local lending institutions, donor agencies address a long standing market failure: the unwillingness of private lending institutions to lend to certain projects or a certain segment of the market due to risk perception. Here donor grant finance shoulders some of the initial risk which lenders would not have been willing to take on in the first place. Thus blending reduces the risk of projects, allowing sub-investment grade projects to become bankable.

In terms of financing structure, Blending typically follows one of the following two arrangements:

- Parallel co-financing, when funding partners contribute separately to a given project or programme;
- Joint co-financing, when funding partners contribute in a joint pooled structure for a given project or programme.

It is via the associated financing structure which includes funding from third parties (public, private, and the beneficiary) that blended instruments are distinguished from concessional loans, which may be provided by a given DFI outside this structure. This is also what sets innovative blending mechanisms apart from previous financial intermediation efforts as well as traditional development assistance such as project and program aid.

Blending structures allow donors to offer a wide variety of financial instruments, ranging from more traditional forms such as direct investment grants and performance based grants, to more unconventional support such as interest rate subsidies, loan guarantees, structured finance, as well as risk capital financing. Additionally these blending instruments may be complemented by technical assistance. Depending on the project context, the different financing structures create different advantages and disadvantages for the donor. Here the objective is to adapt the level of concessionality of finance to best suit the recipients' needs, as well as scale up resources for development purposes to create a form of 'market based' aid (Ferrer et al 2011).

Finally, the emphasis in this thesis is on blended finance which provides risk capital financing to SMEs in the context of private sector development. Risk capital comprises equity and quasi-equity investments that typically carry high risks, i.e. previously unbankable SMEs in partner countries. This form of blended finance aims to fill a market void that was previously ignored: projects which typically generate a return if successful, but which are unable to attract an investor or financier who is ready to participate in developing the project due to its risk level. As a result risk capital has a significant potential to be used as a private sector development tool, given underdeveloped markets are usually characterized by higher risk premia than developed markets.³²

Risk capital may either be offered with other investors, or on a non *pari passu* basis.³³ In case there are other market operators willing to take on the underlying risk on a limited scale, the first financing approach is better suited. Conversely, in situations where market operators are reluctant to bear a certain type of risk, the second approach is most suitable. Here the donor support element may also be used to carve out part of the risk. In both cases donors need to avoid excessive support as this has the potential to crowd out private sector financing, bias investment incentives, as well as impede financial market integration.

3.32 History of Catalytic Aid and Drivers of Blending

Blending is not novel as such. Financial intermediary lending (i.e. lending to either individual banks or wholesaling to multiple banks) as a way of reaching end users was a relatively prominent approach in the 1980s. While loans were the dominant aid instrument until the 1980s, the ensuing debt crisis in developing countries called into question their role in development. Consequently, development finance experienced a general shift from loans to grants.³⁴ Hence by the 1990s this type of lending was very much on the defensive, being replaced by broader efforts at financial sector reform. Today a new form of financial intermediary aid is making a comeback.

As mentioned in the previous chapter, the dual challenge of increased financing needs in developing countries coupled with public deficits in donor countries calling for fiscal

³²In particular risk capital made available to infrastructure projects and SMEs has great added value, given these projects often face very high-risk premia or no access to finance at all.

³³Meaning on a separate basis. *Pari passu* is latin for “on equal footing”.

³⁴Grants still constitute the largest share of traditional ODA channeling.

consolidation and restraint has led to a rethinking of donor aid strategies. The key issue for donors today is how to use scarce financial resources in the most effective and efficient way. There was thus a need to find new alternatives to increase the volume of development financing as well as increase its efficiency and effectiveness.

According to Rogerson (2011) “Catalytic aid has long been associated with graduation from aid, in two once-again fashionable ways” (Rogerson 2011 p. 3). First, development agencies are increasingly acknowledging that private financial flows are now dwarfing aid efforts and are the main driver behind growth in developing countries (Kharas, Jung, and Makino 2011). This is especially true in the case of countries which have graduated into the ranks of middle-income country status and now account for three fourths of the world's absolute poor (Summer 2010). Within this context, the idea surrounding ‘leveraging’ financial resources for development purposes has gained increasing popularity over the last couple of years.

An increasing number of studies point to the logical conclusion that the future of development cooperation will see a heightened interaction with the private sector (Gates 2011). At the MDG Summit in 2010 the UNDP argued that the private sector needed to play a significant role in the attainment of the MDGs. The private sector is an engine for economic growth. Furthermore, pro-growth and pro-development policies can overlap; particularly when growth is broad based and inclusive. As with financial leverage, blending mechanisms are particularly relevant instruments in this context. For instance, giving people and small enterprises better access to finance and markets via risk capital financing contributes to growth by making better use of the country's resources. What is more, it allows poor people to take part in and benefit from the growth process by changing the distribution of relative incomes in their favour.

The second driver behind the resurgence of catalytic aid has to do with the ability of these mechanisms to use scarce grant resources as effectively as possible. According to Bilal and Kratke (2013):

The economic downturn in Europe and resulting increased budget constraints on donors has put pressure on European spending on development -- leveraging developing financing through blending is often

perceived as a means to partly address the requirement to do more with less.
(Bilal and Kratke 2013 p. 4)

This notion has been reinforced by the fact that the cost of aid in many donor countries is high (Steinwand 2012). As will be explored later in this thesis, demonstrating the benefits of blending may thus be a way of nodding to countervailing domestic interests in donor countries. As chapter two explained, donor aid is constrained by collective action problems which will persist in the absence of selective incentives. With fiscal consolidation in donor countries putting downward pressure on aid budgets, donor governments are increasingly starting to care about the costs of aid provision too. Against this backdrop the thesis seeks to explore whether catalytic aid actually provides more value for money for donor aid spent? Answering this question will allow the thesis to analyse the role of innovative finance mechanisms in overcoming some of the collective action problems constraining the aid architecture.

4 Methodology: Measuring Value for Money

Donors give money for a variety of reasons. As detailed in chapter one and two, these can broadly be categorized under commercial, strategic, and altruistic reasons. The amount and composition is determined by the donor's utility function as well as the institutional arrangements which govern the aid allocation process. The aim of this thesis is not to quantify all these varying interests, as these are vast and often vague. Rather, this thesis concentrates on a specific and measurable objective of donor agencies, which many researchers believe will continue to grow in importance in the provision of aid: value for money (Emmi, Ozlem, Maka, Ilan, and Schatz 2011).

The aim of this chapter is to outline the methodology that was used to evaluate whether innovative blending provides more value for money to donor agencies than traditional aid. This chapter begins by reiterating the research question before providing a brief overview of the concept of value for money. This will be followed by a short overview of the aid interventions which served as the case study. Next the chapter will discuss the methodological procedure that will provide us with the analytical framework by which the research question can be empirically evaluated. Finally this chapter will present the data collection methods and outline any possible methodological limitations as well as further research opportunities.

4.1 Research Problem and Research Questions

The central research question that this thesis seeks to address is whether innovative blending can provide more value for money than traditional aid, and if so, where? Answering this question will allow us to consider the potential of innovative finance mechanisms in the context of the collective action discussion, subsequently formulating a number of conclusions concerning their ability to create selective incentives to help overcome the collective action problems highlighted above.

With a view to measuring VfM, this thesis invokes a case study evaluation of an innovative blending intervention compared to traditional aid interventions. The aim of the

case study was to demonstrate what gains were made that would not have been possible without the innovative intervention. In doing so the thesis makes use of a methodological approach known as the program theory approach (Kusek and Rist 2004; Imas, Morra, and Rist 2009; Emmi et al 2011). This methodological approach will allow the thesis to formulate some conclusions surrounding the strengths and weaknesses of blending mechanisms at various levels of the development intervention compared to traditional aid interventions. Furthermore, answering this research question will serve as a basis on which future decisions can be made about shaping donor aid strategies with a view to enhancing the efficiency and effectiveness of their development assistance. Finally, it should add to the academic literature surrounding collective action problems in development assistance.

4.2 Defining Value for Money

Value for Money is generally understood to describe an explicit commitment to achieve the maximum impact possible with the resources that are at the disposal of donor agencies (Emmi et al 2011). The procedure for demonstrating value for money is based on an economic appraisal that compares the economic costs and benefits of alternative funding decisions. To maximise the impact of aid donors need to be aware of the costs associated with giving and whether their intended results were in fact achieved.

While there are varying interpretations of how to measure value and for whom it should matter, the literature agrees that it is generally concerned with a combination of economy, efficiency and effectiveness of the development intervention (Emmi et al 2011). Here economy relates to efficient procurement, efficiency to the delivery of outputs, and effectiveness to achieving the intended outcomes. Thus VfM entails both a quantitative and qualitative aspects.

Over recent years VfM has become an established term, with several donors building VfM estimates into their log frames of policy impact and evaluation (Kusek et al 2004; Emmi et al 2011). It is about outcomes and results and requires a plausible causal relationship between money that is spent and outcomes that are achieved. It is not about focusing on the cost only, or choosing the cheapest possible development intervention.

While VfM has emerged as a much-discussed topic in the development debate, the demand for development agencies to prove their effectiveness and efficiency is far from new. Already in the 1980s and the 1990s development agencies were discussing the need to demonstrate efficiency and effectiveness as well as the best way to achieve outcomes. The proliferation of new development actors over the last decade, however, intensified the scrutiny of donor's efforts in the provision of aid (Lucas, Eyben, and Srodeki 2010). Indeed this can be seen in the context of the aid effectiveness agenda and the push for results-based aid management. Most recently the backlash of the financial crisis underlined this trend.

As a result of the wide-ranging budget cuts that were pronounced by most of the OECD donor countries following the financial crisis, taxpayers have become increasingly sceptical of how the government is spending its money (Emmi et al 2011). Consequently VfM has gained wide currency in the formulation of economic policy imperatives in general. As discussed in chapter one, this is particularly true for development aid, which is typically constrained by actors higher up in government and lacks a natural domestic constituency. Consequently Andrew Harris, the UK's Secretary of State for International Development, made the following pledge to the taxpayers:

Our aim is to spend every penny of every pound of your money wisely and well. We want to squeeze every last ounce of value from it. We owe you that. And I promise you as well that in future, when it comes to international development, we will want to see hard evidence of the impact your money makes. Not just dense and impenetrable budget lines but clear evidence of real effect. (Emmi et al 2011 p. 13)

With regard to the new aid delivery mechanisms there is thus a need to demonstrate whether these can provide more value for money than traditional aid delivery mechanisms. Yet this also raises the question to what extent VfM and the internationally agreed aid effectiveness principles can be reconciled? As discussed in the earlier in this thesis, together with the desire to demonstrate results, the last decade has witnessed donor organisations and academics increasingly considering whether aid as a whole works, and if so under which conditions. This wide ranging interest in aid effectiveness led to the formulation of the Paris Declaration on Aid Effectiveness in 2005, which defined aid effectiveness along the lines of

five principles: ownership, alignment, harmonisation, results, and mutual accountability. Together these principles aimed at influencing donor agencies' allocation of aid and the creation of more transparent and homogenous monitoring procedures.

Against the backdrop of the international principles of aid effectiveness, some aid practitioners classify VfM as being a subset of the aid effectiveness agenda, particularly with regard to the managing for results pillar of the principles (Emmi et al 2011). Yet there are also aspects of the broadly defined aid effectiveness principles which may not reconcile with the VfM debate. According to Melamed (2011):

In some senses, effectiveness and value can be synonymous to each other. But Aid Effectiveness is broader, and tackles institutional and political issues and relationships which VfM doesn't really address. VfM is a subset of Aid Effectiveness. Aid Effectiveness is about deciding what you want to do. VfM is about how to do it best. (Melamed 2011 p. 2)

Hence while VfM can be seen as a subset of aid effectiveness, it is important to understand that effectiveness (in terms of the successful achievement of outcomes) and value for money are not at odds with one another. To put this in other terms, the successful attainment of outcomes is an important component of value for money. Consequently, if the effectiveness of an aid intervention is reduced due to a small cost saving effort, value for money is also reduced.

Ultimately value for money is a tool which is immensely relevant to the development cooperation context. That being said, donors must also be aware of the complexities of the overall development assistance process and the limitations of the value-for-money methodology. It is important that agencies realise that value for money cannot be the only factor in the decision to pursue one form of aid delivery over the other; aside from what value may have been demonstrated in one particular context, they must evaluate what works best on a case by case approach and also consider their own capacity to replicate favourable outcomes. Nonetheless, VfM frameworks enable agencies to put forward a powerful narrative of the real impact and value of their work. As will be discussed below, in relation to the collective action problem donor agencies face, demonstrating VfM may thus play a role

in spurring aid efforts if new delivery mechanisms are perceived as providing better value for money than traditional ODA.

4.3 What is being Evaluated?

One way of evaluating the VfM of blended finance is to review an innovative, pilot project in a recipient country and to compare it to traditional aid delivery instruments. While this case study approach is limited as it provides a “snapshot” and is not representative of all innovative blending facilities, it is a very useful approach when the objective is to gain in-depth understanding of a process, especially when the intervention is innovative or experimental or not well understood (Imas et al 2009).

Initiated and financed by the European Commission, the Risk Capital Facility (RCF) is an innovative blending facility in the form of a revolving investment fund designed to support SME financing in South Africa by providing equity or quasi equity financing to businesses that are non-commercially bankable due to their risk profile. To compensate for such risk, the RCF aims to support Small and Medium Enterprises (SMEs) with i) Business Support Services (BSS), ii) low pricing, and iii) a favorable equity nature of the financing.³⁵

In existence since 2002, the multi-stakeholder RCF has an overall lifespan of twelve years and is a part of the Private Sector Development (PSD) Strategy as defined by the European Community Country Strategy Paper (CSP) and the Multi-annual Indicative Programme (MIP) of the EC. These documents identify the promotion of economic growth, equity and employment as a priority area for cooperation. The main objective of the PSD is to support South Africa in accelerating employment growth in the small and medium enterprise sector. Consequently, the RCFs stated objective is the following:

The overall objective of the Programme is to contribute to the economic growth of South Africa and to promote the participation of Historically Disadvantaged People in its economy. More specifically, its programme purpose aims at job creation, through the provision of financial assistance in

³⁵The pricing was usually lower than the market based rate of interest payable monthly in arrears, plus a sweetener, most often calculated as a percentage of the budgeted turnover. For a comprehensive overview of the financing structure see Appendix E.

the form of equity and quasi-equity to small and medium enterprises. It supports its investments by supplying low or interest-free loans to enable SMEs to acquire technical assistance and training. (RCF Financing Agreement 2000 p. 2)

From the donor perspective, the instrumental objective of this innovative approach is to use traditional grant finance for the nontraditional practice of risk capital financing, leveraging additional development finance and taking advantage of the financial expertise and lending capacities of two DFIs in the process: the Industrial Development Cooperation (IDC) and the European Investment Bank (EIB). Its core objective is to spur human development and poverty alleviation, as well as supporting the empowerment of Historically Disadvantaged Persons (HDPs) within the context of the EC's Private Sector Development Strategy for South Africa.³⁶

Part of the evaluation is to compare the innovative aid modality of risk capital financing to the Commission's traditional interventions. As such, the benefits and complementarity of the RCF to more established aid modalities will be considered. With a view to doing so, this evaluation invokes two counterfactuals for the RCF. First, the evaluation compares the RCF to a traditional EC project grant in South Africa: the Local Economic Development Support Programme in Kwazulu-Natal Province (LED KZN).

For the LED KZN, the financing agreement between the EC and South Africa was signed in 2003 (one year after the implementation of the RCF). It seeks to promote equitable economic growth throughout the KZN province by supporting the provincial Department of Economic Development and Tourism (DEDT), as well as a wide range of other stakeholders involved in the promotion of local economic development. In terms of financing activities, the LED KZN targeted four broad areas of support. First, to assemble stakeholders in a partnership and implement sustainable employment generating investments, as well as enterprise growth plans with pro-poor results. Second, to increase public sector stakeholders engaging in LED relates processes. Third, to assist in sustainable mechanisms for learning, knowledge exchange, information dissemination, and training. And fourth, to create effective LED management functions at the provincial and regional level.

³⁶Given the EC aligns itself with the partner countries' development strategies, the RCF is thus supporting the Broad Based Black Economic Empowerment (BBBEE) policy of the South African.

The EUR 37 million grant support programme was designed to be implemented over a six-year period and to be completed by July 2009. While this serves as a counterfactual with regard to the aid delivery process, its final results in terms of outcomes cannot be compared given there is no comparable control group for the two.

Second, the evaluation will compare the outcomes of the SMEs supported by the RCF to the overall EU private sector support in all recipient countries over the period 2004-2010. The EU provided EUR 2.4 billion in grant funding for PSD over the given period, of which EUR 2 billion was contracted under direct interventions and EUR 400 million was contracted under Sector Budget Support (SBS). This made PSD an important area of aid delivery for the EU, covering a broad range of activities. Among others, these include creating more quality jobs for the economically marginalised, improving business-enabling environment, as well as increasing capacity and skills in the productive sectors of the economy. Additionally it included support for SMEs as well as support for private sector representative organisations. Ultimately it included fostering partnerships and knowledge/technology transfer between enterprises to improve enterprise competitiveness and supporting institutional and regulatory reform and legal/tax frameworks, to enhance the business environment. This broad range of activities will serve as a counterfactual to the RCF where possible.

4.4 Methodological Framework

4.41 Measuring Value for Money

The first myth we need to deconstruct is that value for money is synonymous with monetising everything and applying cost-effectiveness analyses across the board. While these are tools which may be relevant to assessing value for money in some cases, value for money is a much broader concept. Measuring VfM depends largely on the context with which it is being addressed. Here it is important to concede that the VfM of innovative mechanisms such as blending is particularly difficult to measure given their transformative nature, implying that the process of aid delivery played a central role. Consequently real VfM reporting implies institutional knowledge and understanding as well as accountability for

results delivery. From a methodological perspective a case study approach was therefore invaluable as this requires an in depth understanding of the theory of change of the development intervention. According to Kusek and Rist (2004) this entails a representation of how an intervention is expected to lead to desired results.

Theory of change models typically have five main components: inputs, activities, outputs, outcomes, and impacts. The foundations for this approach lie with the work of the 1930s sociologist Mannheim (1935, 1967), who appealed for the construction of underlying assumptions when evaluating “social planning”. Later, in the 1950s, Van Doorn came up with the term “policy theory”, which in the field of evaluation gave rise to the term “program theory” (Rogers, Hacsí, Petrosino, and Huebner 2000). According to Rogers et al (2000), a program theory defines an explicit theory or model of how a development intervention is to achieve its intended outcomes.

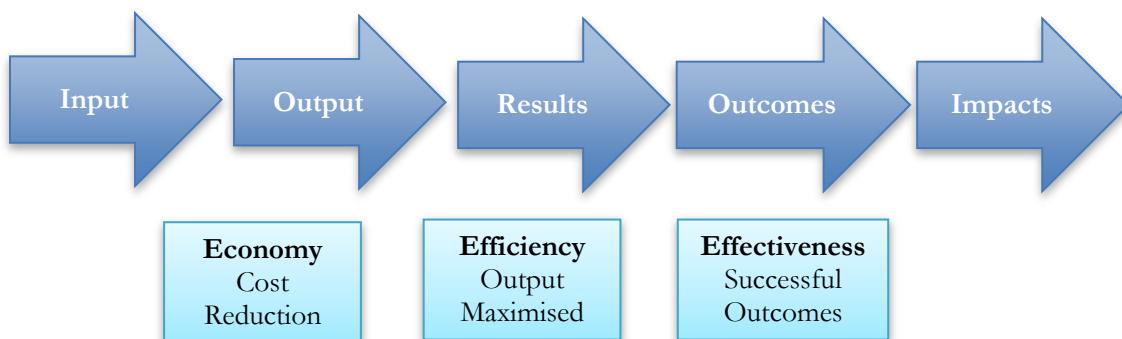
In 1969 a version of the program theory, the logical framework approach, was developed by Practical Concepts Incorporated (1979). This approach was subsequently developed further for project planning and evaluation by the *Gesellschaft fuer Technische Zusammenarbeit* (GTZ),³⁷ the German international development agency. In the methodological log frame, the causal chain was standardized into four components: activities, outputs, purpose (rationale for producing outputs), and goal (a higher level objective to which the project was to contribute). For each of these stages a number of aspects were developed: a narrative description, objectively verifiable indicators, means of verification, as well as assumptions.

This log frame served as the basis for the program theory approach which gained wide currency in the 1980s. A number of publications contributed to the development and popularization of this approach. Chen and Rossi published several books and articles on theory driven evaluations (Chen and Rossi 1980, 1983, 1987). In 1989 Chen served as a guest editor for a special edition of the journal ‘Evaluation and Program Planning’, which discussed key issues, different types of models (Lipsey and Pollard 1989), ways to address validity (Scott and Sechrest 1989) and barriers to use (Bickman 1989). Furthermore, in response to the economic challenges during the 1980s, many donor countries adopted the use of program theory to focus on managing for results.

³⁷Society for Technical Cooperation.

The most recent economic challenges faced by donor countries have prompted a renewed use of this evaluation methodology with a view to measuring VfM. Using a results chain as depicted in Figure 4.1 below, Emmi et al (2011 p. 7) stress that many policymakers and academics define value in terms of the process of aid delivery, i.e. “the causal logic or pathway through which a set of interventions is expected to lead to a long-term goal”. According to the literature, the value of the development intervention can be measured at different stages from inputs through to impacts of the program theory.

Figure 4.1: Conceptualising Value for Money



Source: Adapted from Binnendijk (2000).

As outlined at the beginning of this chapter, VfM is generally concerned with the economy relating to efficient procurement, efficiency of the delivery of outputs, and the effectiveness in achieving the intended outcomes (Emmi et al 2011). As will be discussed below, in order to demonstrate the value for money of the RCF, the evaluation provides an assessment of both the process and the ultimate outcomes of the aid delivery compared to respective counterfactuals. This also includes a rigorous assessment of the relationship between the RCF and its intended objectives. Ultimately, this evaluation methodology facilitates an empirical evaluation of the relative benefits and weaknesses of two different forms of aid delivery in the context of the donor’s development assistance objectives.

4.42 Evaluation Methodology

With a view to measuring the VfM of the RCF against its counterfactuals, the evaluation reconstructed the underlying program theory and the operational logic of the donor when

providing development assistance. Specifically this meant reconstructing the European Commission's objectives in terms of aid delivery as well as the process of channelling aid via a single hierarchy of donor objectives. This allowed the thesis to define VfM and formulate a number of evaluation questions and indicators to measure it.

While there is no one size fits all approach to determining value, using a reconstructed program theory allows us to measure what matters, to measure comparably, and to determine whether value for money has been secured and specifically where. The assessment of VfM thus involves examining the driving factors of VfM, identifying the links between them and drawing conclusions based on evidence about how well they perform together.

While defining outcomes and impacts is not easy, the reconstructed program theory provides the basis for doing so by providing a better understanding of the causal mechanisms at play in a development intervention (Brouselle et al 2011). In doing so, it is imperative to understand that the evaluation required an assessment of both the degree of achievement of the donor's objectives with regard to aid delivery, as well as the process of channelling aid. Hence the evaluation focuses on what can be described as a two-dimensional reconstructed program theory.

The reconstructed program theory consists of an explicit articulation (graphic display) of the different levels or linkages of expected results from the development intervention. According to Kusek and Rist (2004), defining cause-effect linkages lays the foundation for the reconstructed program theory. Once the linkages between these components has been established, the evaluation is able to determine the main drivers of VfM and formulate cause and effect questions with regard to the objectives that the donor pursued with the innovative RCF. The aim of these questions was to demonstrate what gains were made that would not have been possible without the RCF. Using baseline indicators (quantitative or qualitative) and by using comparative case study data, the evaluation measured against counterfactuals where possible.

Hence, in terms of specific outputs, this evaluation aimed to:

1. Reconstruct the donor's program theory on the basis of overall donor objectives in question;
2. Identify the driving factors of VfM at the various levels of the intervention and formulate Evaluation Questions (EQs);

3. Assess the delivery of this innovative facility against its counterfactuals and formulate answers to the Evaluation Questions.

On the basis of these outputs, the thesis will be able to formulate conclusions on the core research question at hand, consequently highlighting the VfM of blending mechanisms *vis a vis* traditional aid modalities.

4.43 Overview of Evaluation Process

With a view to providing evidence-based answers to the research question, this thesis employed a methodological approach consisting of carefully structured stages (as shown in Figure 4.2).

Figure 4.2: Evaluation Process

	Identification Phase	Field Phase	Assessment Phase
Tasks	1) Creation of reconstructed program theory 2) Identification of evaluation questions and judgment criteria 3) Selection of case studies 4) Determination of observations and preliminary findings 5) Identification of information gaps 6) Data collection 7) Interviews with IDC, EC and EIB.	1) Focused research (South Africa and EU headquarters in Belgium) 2) Additional interviews with stakeholders 3) Consultation with IDC, EC and EIB	1) Responses to evaluation questions 2) Overall judgment, conclusions, and recommendations 3) Feedback/Consultation with IDC, EC and EIB

The first stage was the identification stage, which served to provide a broad overview of the evaluation subject. Consequently a detailed overview of innovative funds channeled by the European Commission was constructed, on the basis of which the RCF was selected.

Following the overview of innovative funding efforts and identification of the RCF, the next step was to determine the manner in which VfM was to be measured. Here the evaluation framework relied on two key elements. First, the reconstructed program theory of the EC when channelling development assistance to the RCF, and second, the determination of evaluation questions on this basis. At this stage two counterfactuals were selected, notably the EC's LED KZN for measuring the cost efficiency and leverage effect of the innovative RCF as well as a basket of EU interventions in the area of private sector development for comparing the outcomes related to employment creation and SME financing. Hereby it was possible to determine the exact data necessary for answering the evaluation questions by specifying the judgement criteria and indicators.

Following the identification stage, the field phase consisted of data collection and was conducted in three phases. The first phase included a desktop review, which was based on an analysis of documents and data, as well as interviews at EIB, EC and IDC headquarters. The second phase involved visits to IDC, EC and EIB headquarters in South Africa and Belgium. Finally, the third phase involved a survey questionnaire for RCF task managers. Based on preliminary findings from the desk study and headquarters visit, the survey questionnaire included targeted questions to fill information gaps.

The last step involved constructing answers to the evaluation questions based on the analysis of the data collected. Using the indicators and judgment criteria as building blocks the thesis formulated balanced answers for each evaluation question. The evaluation used triangulation, which is the use of three or more sources, types of information, or types of analysis to verify and substantiate an assessment by crosschecking results (Imas et al 2009). Hence information gathered from interviews, reports, and the survey was pooled and crosschecked, serving as a foundation for formulating the findings.

Since data analysis should stem from the evaluation questions, the evaluation followed this analytical framework. The first step of this process includes reading through the data and identifying potential themes. Here analysing qualitative data allowed for insights into processes that quantitative data could not. Hence using the qualitative interviews to complement the quantitative data obtained from the IDC and the EIB was crucial for examining causality and trends witnessed throughout the implementation of the development intervention. With a view to testing the findings obtained in this manner, representatives of the IDC, EC and the EIB were consulted on the factual accuracy.

Ultimately, conclusions were formulated on this basis and an overall assessment of the VfM was provided.

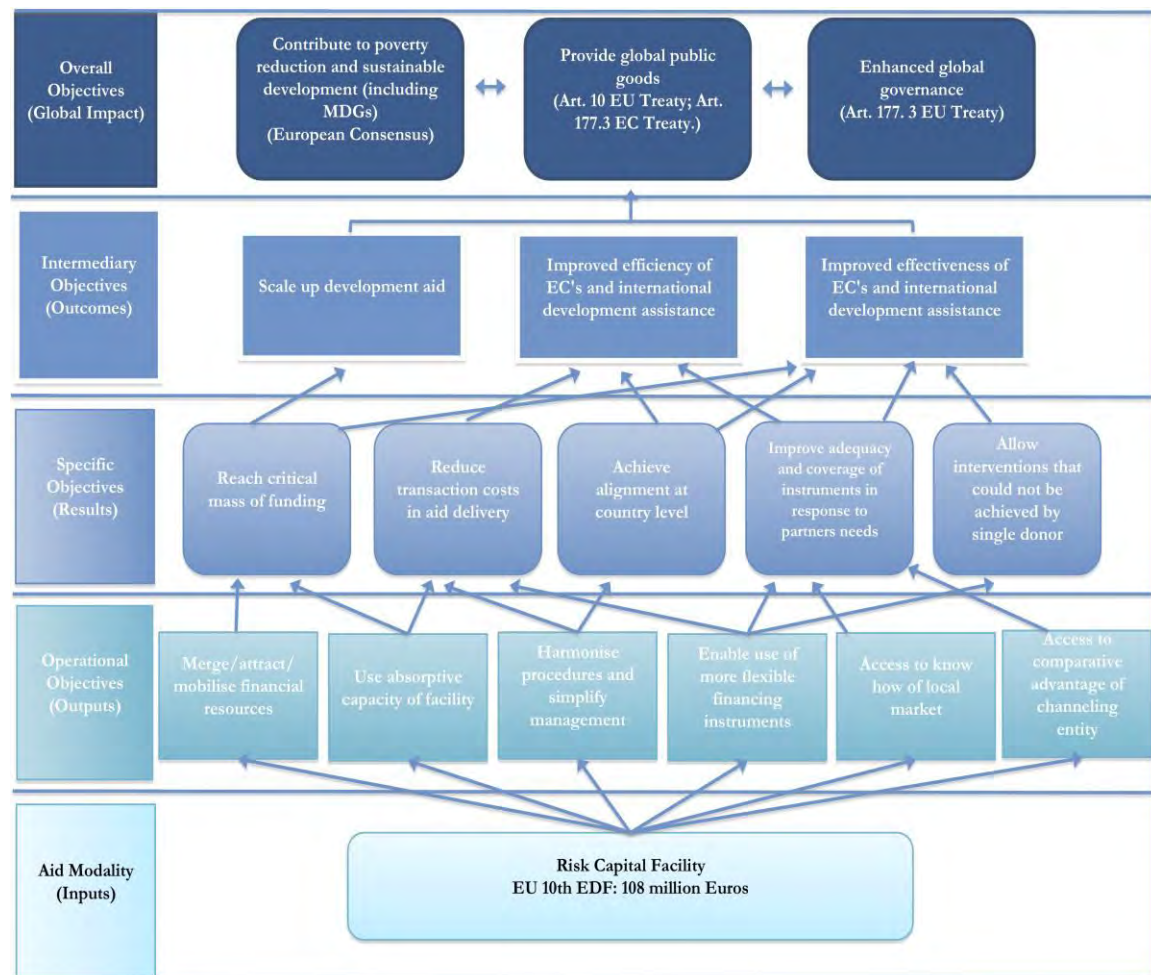
4.44 Building the Reconstructed Program Theory

With a view to identifying and measuring the value of the development intervention at different stages from inputs through to outcomes, the evaluation first had to reconstruct the underlying program theory of the innovative instrument to be evaluated (see Figure 4.3). This subsequently allowed the evaluation to formulate a number of evaluation questions, judgement criteria, and indicators to compare and measure the VfM for the innovative RCF against its counterfactuals.

Based on the work of Imas et al (2009), the reconstructed program theory starts with considering the research question and desired outcomes. Here the evaluation had to ask itself what the starting point of the intervention is and what results it wants to achieve. Simultaneously, the evaluation had to consider several factors, including the broader context of the evaluation, previous research and evaluation on the area to be studied, as well as the assumptions concerning the development interventions. Given the innovative nature of the intervention, the reconstructed program theory can only draw on existing experiences to a certain extent and is therefore exploratory by nature.

After the initial identification phase, the next step involved specifying the linkages, or results chain, and presenting it in a graphic display. According to Patton (2002), the intervention model must portray a reasonable, defensible, and sequential order of linkages. Here the evaluation followed a number of steps to identify causal links between inputs, activities, outputs, outcomes and global impacts with the aim of creating a visual representation of the reconstructed program theory. Here the arrows in the diagram show the specific links with the lower level. For instance, simplifying the management of complex interventions and allowing for more flexible financing instruments is an operational objective which aims to create value by reducing the transaction costs of aid delivery.

Figure 4.3: Reconstructed Program Theory for the Risk Capital Facility



Source: Imas et al (2009) and author.

The reconstructed model consists of five distinct layers: inputs (modalities), outputs (operational objectives), results (specific objectives), outcomes (intermediate objectives) and impacts (overall objectives). At the lowest level of the diagram we identify the input of the intervention, notably the innovative modality under assessment. The RCF is associated with specific activities which are the inputs of the process. The resulting outputs of these activities thus relate to the operational objectives, which make up the first level of the objectives diagram. These operational objectives were identified on the basis of the RCF's project programming documents (i.e. financing proposals) accompanying the identification and implementation of the innovative modality.

With a view to constructing this model, a number of “if-then” statements comprise the linkages. Here the evaluation had to work backwards, starting with the identification of the overall objectives (impacts) for the intervention to achieve, i.e. the overarching goals pursued by all the external aid activities of the European Commission. Next, determining whether the inputs and the operational objectives (outputs) contribute to overarching goals (impacts) of the highest level in the objectives diagram was determined through a string of intermediate (outcomes) and specific objectives (results). These linkages were derived from a number of mutually supporting and interlinked EU strategy documents as well as documents governing the channelling of the donor grant.³⁸

Ultimately the reconstructed program theory was important in the sense that, firstly, it defined the hierarchy of objectives of the donor, and secondly, it demonstrated how this innovative aid delivery process was to contribute to the EU’s development cooperation policy objectives. This allowed for a visual representation of the causal links between the innovative RCF and how it is to achieve the objectives for the donor. The model therefore provided both the benchmark against which to evaluate this innovative facility and its counterfactuals, as well as the basis for identifying drivers of VfM and formulating evaluation questions and indicators on that basis.

4.45 Determining Value for Money: Evaluation Questions

As demonstrated in Figure 4.3 above, addressing the EC’s objectives in terms of aid delivery as well as the process of channelling aid via a single hierarchy of donor objectives served as the basis for the underlying program theory. This allowed the thesis to define VfM and formulate a number of evaluation questions and indicators to measure it (see Figure 4.4). Based on the assumptions and linkages identified in the reconstructed model, the evaluation was able to formulate cause and effect questions with regard to the objectives that the donor pursued with the innovative RCF. The aim of these questions was to demonstrate the VfM for the RCF and whether gains were made that would not have been possible without the RCF.³⁹

³⁸See Appendix C for detailed overview of documents consulted in the construction of the underlying program theory.

³⁹The Evaluation Questions address the three principles of VfM: *Economy, Effectiveness and Efficiency*.

Figure 4.4: Evaluation Questions for Measuring VfM

Evaluation Question 1 on Scaling Up

Did channelling aid to the innovative RCF facilitate the scaling up of development resources for the European Commission compared to the traditional LED KZN?

(Effectiveness and Economy)

Evaluation Question 2 on Follow Up and Coherence

Did the donor ensure coherence of development objectives pursued and was he capable of following up on results when providing grant finance to the innovative RCF? How did this compare to the provision of the EU's global private sector development interventions?

(Effectiveness and Efficiency)

Evaluation Question 3 on Results/Impacts

To what degree did channelling to this innovative facility contribute in a sustainable manner to achieving the intervention objectives the donor targeted when channelling its funds? How do the results compare to broader SME support in South Africa as well as the EU's global

PSD financing?

(Effectiveness and Efficiency)

Evaluation Question 4 on Expertise

To what degree did channelling to the innovative RCF enable the European Commission to offer a broader range of instruments and expertise to the recipients compared to the traditional LED KZN?

(Effectiveness and Efficiency)

Evaluation Question 5 on Cost Reduction/Implementation

To what degree did the channelling of funds to the innovative RCF contribute to swifter implementation and lower transaction costs than the LED KZN?

(Efficiency)

Based on the reconstructed donor objectives, this evaluation aims to measure value for money of the RCF against counterfactuals at various points of the intervention based on the

criteria defined in the evaluation questions above. These include the ability to leverage additional development finances, results and outcomes at the beneficiary level, the provision of financial expertise, and the cost of aid delivery. With a view to formulating answers to the evaluation questions and thus the overarching research question, the evaluation questions are further broken down into judgment criteria and performance indicators.⁴⁰

With regard to defining the indicators, they were targeted to be as specific, measurable, and relevant as possible. By comparing actual results of the RCF and its counterfactuals against indicators it was possible to measure the performance of the innovative facility. Additionally, the evaluation considers data and results other than predefined indicators. On this basis the evaluation was able to formulate evidence-based answers, overall findings and key lessons learnt with regard to the assessment of the delivery of the programme and achievement of VfM.

4.46 Data Collection Tools

Throughout the evaluation, the thesis employed a number of data collection tools, including donor reports, interviews, and a survey questionnaire. For the overview of funds channeled, data collection aimed at being as comprehensive as possible and consequently covered the IDC, EC and the EIB reports solicited. This included the Medium Term Reviews and Results Oriented Monitoring reports of the RCF and its counterfactuals. These were made available by the EC staff and provided information complementary to the other sources. In addition to specific project related documents, additional information was identified via a review of crosscutting strategic documents by the EC, IDC and the EIB.⁴¹

With regards to interviews, two forms of interviews were conducted during this evaluation, notably face-to-face interviews and telephone interviews. Face-to-face interviews were held in two phases: initially at the start of the evaluation in order to have a comprehensive view of the channeling of funds through the IDC and EIB, and subsequently, during the desk phase to gain information and insights on the RCF and its counterfactuals. Prior to some of the interviews, a letter sent by the PhD supervisors introduced the research. The interviews were either open, allowing for a broad

⁴⁰Please refer to Appendix C for further details on Evaluation Questions.

⁴¹See the Bibliography for a complete overview of the RCF documents consulted.

understanding and to identify the major topics and issues, or semi-structured, using a questionnaire based on information gaps identified.

Telephone interviews were carefully prepared on the basis of specific questions addressing issues under investigation. They were carried out throughout the evaluation process for specific topics (i.e. EC management time, IDC pricing issues, etc.), as well as after the analysis of the survey results so as to clarify and deepen some specific aspects of the answers to the survey.

In total over 40 interviews were organized (most interviewees were met in person). Meetings were for the most part recorded and the main findings noted after each interview. The interviews were carried out with the following persons:

1. Commission staff in Pretoria Delegation over the course of three visits;
2. Commission staff at headquarters in Brussels (Belgium);
3. EIB staff in South Africa;
4. IDC staff at headquarters in Johannesburg over the course of three visits;
5. Managing Directors of two SMEs funded by the RCF;
6. Key stakeholders such as representatives of other donor agencies and DFPs (e.g. KfW Development Bank), as well as private sector representatives (i.e. INVESTEC, ABSA).⁴²

Finally, a comprehensive survey questionnaire was sent to Commission staff in South Africa and Brussels, IDC staff in Johannesburg, as well as to the EIB task manager in Luxembourg. The questionnaire identifies the four overarching Evaluation Questions, which are broken down into Judgment Criteria and Indicators. The purpose was to tackle, for each Evaluation Question, the main issues identified throughout the identification phase.⁴³ The survey also consisted of a short explanatory note and a clarification note on specific terms used in the questions. Several re-launches of the questionnaire were undertaken to increase the number of responses. Furthermore, on the basis of the survey responses, several telephone interviews were carried out to clarify and deepen some of the responses.

⁴²ABSA (the Barclays Africa Group Limited) is one of Africa's major financial services providers offering personal and business banking. Investec is an international specialist banking and asset management group.

⁴³See Appendix F for a sample survey questionnaire and responses.

4.47 Possible Methodological Limitations and Further Research Opportunities

It is not straightforward to evaluate blending facilities. The following is an overview of common sources of bias and potential methodological problems with this evaluation. First, when comparing traditional aid delivery to innovative blending there exists a limited counterfactual in terms of the ultimate beneficiary. While the RCF directly supports a segment of the SME sector in South Africa via a local DFI, its counterfactuals support the development of the private sector via support for national reform strategies through budget support or working with local government institutions and stakeholders via project aid. Consequently it is difficult to identify a comparable control group for the two forms of aid delivery at the beneficiary level. That being said, the evaluation does invoke a counterfactual with regard to access to finance and employment creation at the results level, as well as a counterfactual comparing the efficiency and effectiveness of the aid delivery process.

Second, there is a lack of data with regard to the impact in terms of economic and social effects of the blended project over time. While the results provide an indication of possible impacts, a proper impact assessment was not possible given the recent nature of the RCF and the lack of monitoring data collected by the implementing institutions. As a result of these information gaps the evaluation does not allow for comprehensive impact analysis. To get a real picture of the socio-economic impact of the facility in South Africa, the development of the investees needs to be closely monitored over time. This would thus be an interesting point of departure for future research on the topic.

Third, the evaluation was confronted with limited pre-existent knowledge and research on the topic of donor driven risk capital financing. As a result, there may be various ways to build on this evaluation in the future.

Fourth, there is some risk of bias in working with qualitative data as evaluators and interviewees may see what they want to see and miss things that do not conform to their expectations. Nonetheless, given the multi-stakeholder approach to this development intervention, the evaluation covered information from a number of different perspectives, which allowed for the identification of themes as well as a comprehensive understanding of the data.

Fifth, the case study approach is limited as it provides a “snapshot” and is not representative of all blending facilities. Nonetheless, it is a very useful approach when the

intervention is innovative or experimental and the objective is to gain in-depth understanding of a process (Imas et al 2009). Case studies emphasize more than descriptions; they also include interpretations of situations by those most knowledgeable about them. Consequently this approach could be used to evaluate more innovative mechanisms beyond blending in the future. In particular catalytic mechanisms and public private partnerships merit further study as they allow for the private sector to play a role in development. This would involve analysing the strengths and weaknesses of these mechanisms, what governance structures work best, and whether they can increase the effectiveness of aid delivery.

Sixth, as outlined above, there is no one size fits all approach to measuring value. This is all the more true when it comes to measuring innovative development interventions against established development aid instruments. Nonetheless, while measuring VfM for the innovative RCF requires a largely qualitative approach, this also poses an opportunity to demonstrate what else represents ‘value’ and to improve the ways of measuring it.

Finally, the reconstructed program theory does not measure commercial and strategic interests that may be at play in the provision of EU aid. This is in part due to the difficulty in reconstructing these in the donor’s underlying program theory, but also due to the fact that the research question chose to focus on a specific and measurable donor objective in the form of value for money. Rather than to building a ‘catch all’ model of donor interests, this approach allowed us to build our reconstructed program theory on mutually supporting and interlinked EU strategy documents as well as documents governing the channelling of the donor grant. That being said, expanding this model would be an interesting point of departure for more research on the topic in the future.

5 Case Study Results: Value for Money of European Commission Blending in South Africa

Before presenting the results of this evaluation, this chapter provides a brief overview of the aid modalities which served as the case studies for this evaluation.⁴⁴ Thereafter, the results of the five evaluation questions outlined in the previous chapter will be presented. These results will serve as a basis for answering the research question around whether innovative blending may provide more value for money than traditional aid.

5.1 Overview of Case Studies: Project Structures and Activities

5.1.1 Case Study Overview

In terms of the aid interventions that were selected, the case study evaluation focused on one innovative blending facility and invoked two traditional forms of aid delivery as counterfactuals (see Figure 5.1). The counterfactuals included one project aid modality, as well as a basket of EU financed aid interventions. All aid modalities evaluated were financed in the context of private sector development.⁴⁵

The innovative blending modality evaluated consisted of the European Commission financed Risk Capital Facility in South Africa. Launched in 2002, the RCF is an associated financing structure consisting of a number of stakeholders. Grant funding in the amount of EUR 108 million was provided by the European Commission through South Africa's Department of Trade and Industry (DTI) over two financing cycles. The Industrial Development Cooperation, South Africa's oldest DFI, co-manages the fund with the European Investment Bank. Furthermore the RCF was set up in a way that includes the possibility for third parties to contribute.

⁴⁴For more details on the Methodology, including a definition of South Africa's SME sector, please refer to Appendixes C and D.

⁴⁵EU private sector development encompasses a multitude of activities, including efforts to promote SME development, access to financing, employment generation and poverty eradication.

The main agreement is a Financing Agreement (FA) between the EC and the Republic of South Africa. On the basis of this legal agreement between the EC and the DTI, the RCF was structured as a ring fenced entity within the IDC.⁴⁶ Additionally, the EIB has been contracted to act as a co-manager of the RCF Programme. Its role is to provide support with regard to each investment decision, as well as provide the EC with an independent assessment of the performance of the facility.

Figure 5.1: Overview of Interventions

	Risk Capital Facility	Local Economic Development Support Program Kwazulu Natal	EU Private Sector Support
Project Type	Innovative Blending	Project aid	Basket of interventions
Implementation Agency	Industrial Development Cooperation	Kwazulu Natal Department of Economic Development and Tourism	European Commission/Local partners
Grant Size	EUR 108 million over two financing cycles	EUR 37 million	EUR 2.4 billion
Duration	Twelve years	Six years	Seven years
Implementation Period	March 2002 - January 2014	January 2004 - December 2009	January 2004 - December 2010

The first counterfactual to the RCF is the LED KZN support programme in KwaZulu-Natal. Launched two years after the RCF, the LED KZN Financing Agreement committed the European Union to an amount of EUR 37 million. Additionally the LED KZN support programme was co-financed by national, provincial, and local government.⁴⁷ Like the

⁴⁶On the basis of a separate MOA between the DTI and the IDC. Within the IDC a special structure was set up. This included the RCF unit, later transformed into the Strategic Business Unit (SBU) (to look after the SME financing.)

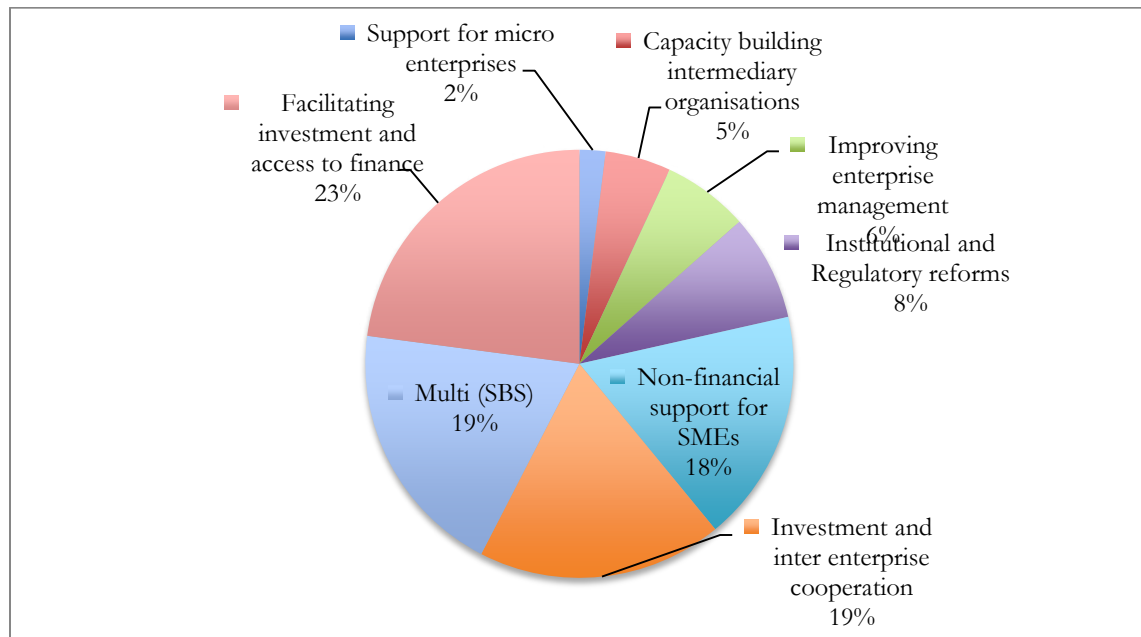
⁴⁷The total programme costs are estimated to be of EUR 473 million, with a contribution of EUR 436 million from the government and the remainder from the EC.

innovative RCF, it is part of the EC's Private Sector Development Strategy for South Africa. Within the context of the evolution of aid modalities, the LED KZN represents a traditional project aid delivery modality.

The core problem to which the LED KZN programme responds is market failures as well as human and institutional capacity shortcomings in the province of KwaZulu Natal. The key objective of the LED KZN is thus to improve local economic development. With a view to doing so, this aid intervention supports the provincial Department of Economic Development and Tourism and a broad range of other stakeholders to push for equitable economic growth in KZN. The target groups include local and district municipalities and partnership groups comprised of private companies, community based non-governmental organisations, as well as trusts and associations active within the local economy.

Finally, the thesis invoked a second counterfactual to the innovative RCF in the form of a basket of EU interventions in the thematic area of private sector development over the period 2004 until 2010. This support totaled EUR 2.4 billion directly contracted by the Commission and covered support in all regions where PSD aid was implemented. EU private sector development encompasses a multitude of activities, including efforts to promote access to financing, employment generation, poverty eradication, as well as SME development and financing (European Commission 2003a). As the Figure 5.2 indicates, the majority of the EUR 2.4 billion was used for four intervention areas: facilitation of investment and access to finance, Sector Budget Support contracts, investment and inter-enterprise cooperation, and non-financial support for SMEs. This comprised 80% (EUR 1.92 billion) of total direct support. The remaining 20% (EUR 524 million) was divided among the remaining four intervention areas. About half of the EC's private sector development support went to the European Neighborhood countries and Russia (EUR 1.2 billion), with another third being contracted in the African, Caribbean, and Pacific (ACP) regions (EUR 803 million). The remaining amount included interventions in Latin America and Asia (EUR 389 million).

Figure 5.2: EU PSD Distribution by Area of Intervention



Source: ADE (2013).

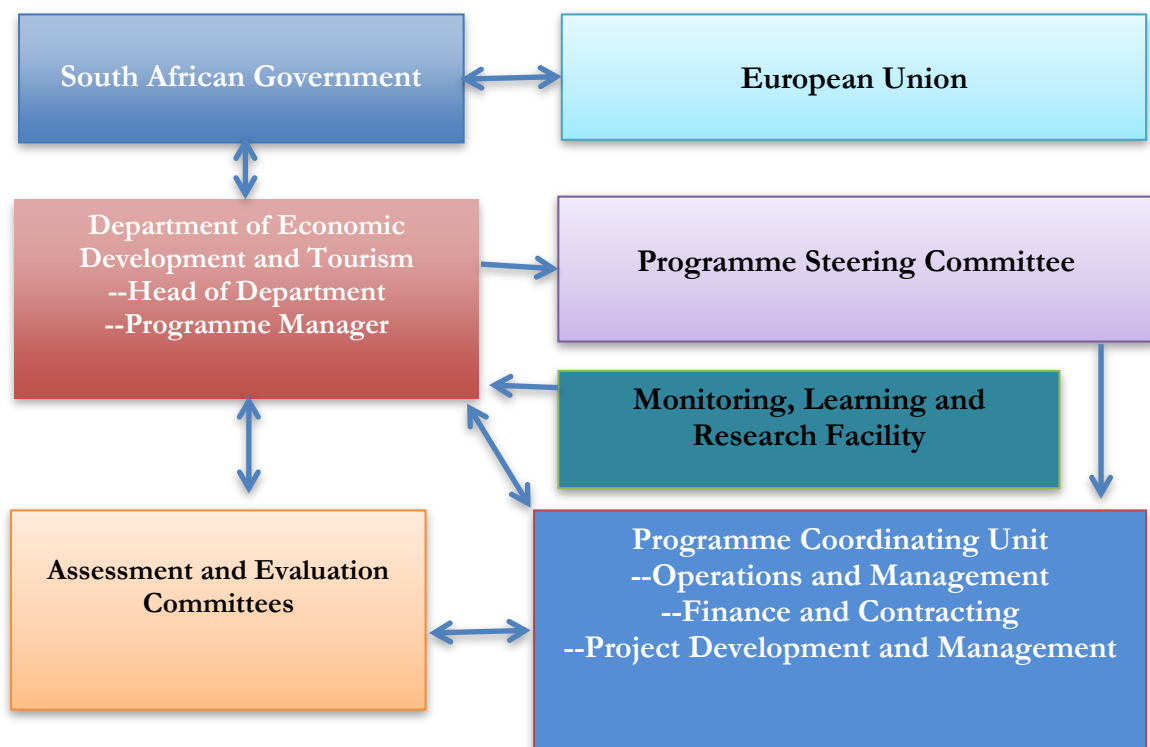
5.12 Implementation Structures

Traditional EU PSD support consisted of a broad range of implementation structures. These include project support, regional and centralized program support, as well as general and sectoral budget support. Depending on the instrument in question, EU PSD support was either provided via government departments with resources to partner with provincial and local organisations, local or international DFIs, research centres, or via civil society.

In the case of the LED KZN, donor aid was delivered via the EU's project modality. In this case donor grant funds were committed to a local implementing institution, the provincial Department of Economic Development and Tourism, which was also the contracting authority of the intervention (see Figure 5.3). Concerning project management, the Programme Steering Committee (PSC) of the LED KZN held the function of overseeing the entire programme and acting as an advisory body to the Department of Economic Development and Tourism. Moreover, the day-to-day management of the LED KZN was assigned to a Programme Co-ordinating Unit (PCU), which was responsible for

supporting the implementing institution with the management of the project. The PCU was organized so as to ensure a separation of responsibility between two entities. First, the Project Development and Management Team (PDMT), which provided technical assistance to assist local authorities and their partners to identify projects for submission for grant financing. And second, a Finance and Contracting Unit (FCU), responsible for arbitrating, awarding and contracting grants.

Figure 5.3: LED KZN Implementation Structure

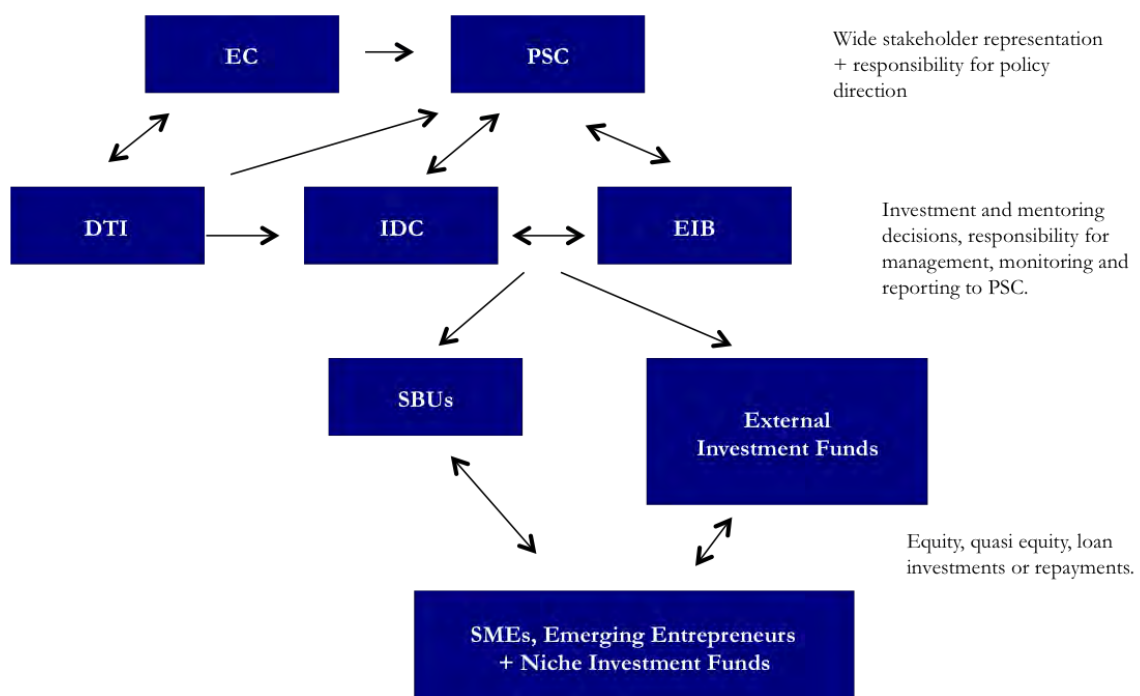


The implementation structure of the innovative blending modality differed from that of traditional aid modalities. The RCF consists of a ring fenced investment facility financed by the donor and various public and private entities within the recipient country. In contrast to the EUs traditional aid modalities, the RCF operated through a three-tiered governance structure involving the EU, the EIB, and the IDC. Here the EIB drove the project identification process, submitting project proposals to the EU. As the lead financier, the EU subsequently had to approve the intervention within the context of its PSD strategy in the

recipient country. Finally, the EU delegated the implementation and management of the facility to a local DFI and the European Investment Bank.

The organizational structure of the RCF within the IDC has changed since its inception (see Figure 5.4). Initially, an RCF unit was in charge solely for the implementation of the multi-stakeholder facility.⁴⁸ However, since 2009, the IDC transformed the RCF team into a larger, more far reaching unit called the Strategic Business Unit (SBU).

Figure 5.4: RCF Implementation Structure



With regard to project management and guidance in terms of policy direction, the main decision making entity is the Programme Steering Committee. Chaired by the DTI, the committee consists of representatives from various institutions, including the South African Banking Council, Business Partners (a South African private sector lending institution), as

⁴⁸ Initially comprised of two, and later three Accounts Officers in charge of the pre-investment phase, as well as post-commitment follow-ups. The RCF unit was completed by two Assistant Officers and a Head of Unit.

well as civil society representatives.⁴⁹ The PSC may also be attended by other government departments with a stake in SME development, as well as representatives of third parties contributing to the facility.

Being the implementing institution, the IDC was central to the success or failure of the RCF. It acts as the secretariat of the PSC, preparing quarterly reports, reviewing portfolio developments, as well as progress towards the RCFs development goals. The EIB attends the PSC as a technical adviser, while the European Commission participates with an observer status. The IDC also provides assistance to the RCF via its various established departments, taking stock of its professional expertise in various fields of operation. This includes assisting with the analysis of risks, pricing guidance, sectoral expertise, business support, accounting, as well as monitoring support.

5.13 Financing Instruments

The financing instruments differed quite substantially between the aid modalities evaluated. General PSD support by the EU covers a wide set of instruments which allow it to address a comprehensive range of PSD needs in the different regions. However due to a lack of tailor made support systems, traditional PSD support has generally been unable to facilitate more direct involvement of the private sector. Indeed, traditional project aid modalities mostly provided grants through provincial partners in recipient countries. In the case of the LED KZN project financing was provided via the Department of Economic Development and Tourism KZN.⁵⁰ Comparably, the RCF offers equity and quasi equity financing via shares, preference shares, subordinated loans, and convertible bonds to SMEs in South Africa. It also offers technical support via its Business Support Services.

The RCF provides SME financing via three channels. First, a Direct Channel (DC) which runs along with the IDC's conventional lending. This channel consisted of direct co-financing with IDC funds and was targeted to provide between 50% and 60% of the RCF's lending.⁵¹ Second, the RCF operates a Niche Fund Channel (NFC)⁵² which attracts venture

⁴⁹Civil society is co-opted to the PSC through institutions such as the Black Economic Empowerment Commission, National Economic Development and Labour Council (NEDLAC) and the Banking Council.

⁵⁰Also some project financing was provided via Trade and Investment KZN (TIK) and Ithala (KZN's provincial public development finance entity).

⁵¹As stipulated in an EIB – IDC agreement defining the investment guidelines (EIB 2002).

capital funds that target sectors with a developmental focus. The maximum investment for the niche fund channel was determined at ZAR 30 million. Here the respective weighting of financing was targeted at 25% to 30% of the total RCF lending. Third, the RCF envisaged a Third Party Channel (TPC), which co-invests with other financial institutions. The respective weighting of this financing channel was deemed to be between 15% and 20% of the RCF's lending.⁵³

5.2 Evaluation Questions and Results

5.21 *Scaling Up Aid*

Evaluation Question 1: Did the RCF channelling facilitate the scaling up of development finance compared to the LED KZN?

The aim of this evaluation question is to explore whether the RCF contributed VfM for the donor in terms of scaling-up of development finance. With a view to measuring this, the evaluation assessed the RCF's ability to, first, use donor resources in such a way that takes advantage of the absorptive capacity of the local DFI, second, to mobilise additional financial resources, and third, to facilitate sector and policy leverage in the area of the donor's Private Sector Development strategy.⁵⁴ With a view to measuring this leverage effect against counterfactuals, the evaluation compared the RCF's results with those of the traditional LED KZN. Consequently this question addresses the *effectiveness* and *impact* criteria in our reconstructed program theory, as it aims at verifying the transformation of outputs (i.e. value of absorption capacity/attracting financial resources) into results (realizing critical mass of funding) and finally intermediate impacts (scaling up development efforts).

With regard to the first point, the evaluation explored whether the absorptive capacity of the IDC facilitated the disbursement of EC funds? Based on interviews and the survey questionnaire, the evaluation found that the Commission's decision to channel its grant

⁵²The maximum investment for the niche fund channel is ZAR 30 million.

⁵³For the Niche Fund financing and Third Party financing the RCF has to conduct its own direct marketing, while for the Direct Channel it is up to the IDC to market the RCF and identify potential SME projects.

⁵⁴ As defined by the European Community Country Strategy Paper (CSP) and the Multi-annual Indicative Programme (MIP) of the EC.

finance to the innovative RCF was primarily linked to the absorptive capacity of the IDC. EU staff interviewed noted that the donor does not have the ability nor the expertise to directly lend to the private sector.⁵⁵ Indeed, the IDC's capability and experience as a lending institution in South Africa has given it the technical expertise in a wide range of sectors. As a result it had created the necessary infrastructure to implement such an operation as the RCF. What is more, channeling through the IDC offered access to significant country presence and experience, where the Commission was either not experienced enough or simply has too little critical mass in terms of human resources.

As a result, the ability of the IDC to provide the EC with a private sector lending capacity and expertise played a key role. What is more, the partnership was seen as an instrumental objective to facilitate the attainment of the ECs objective to accelerate employment growth in the SME sector in South Africa.

While the IDC allowed the EC to make use of an absorptive capacity that it could not facilitate by itself, the evaluation revealed that the absorptive capacity of the implementing DFI was constrained by various factors. First, the RCF unit responsible for managing the investment facility was overly reliant on the IDC's mainstream business units, particularly with regard to deal making and marketing to the target SMEs.⁵⁶ Second, RCF lending was constrained by overly rigid criteria in the Financing Agreement and investment guidelines.⁵⁷ And third, the RCF never disbursed via the 'Third Party Channel', which envisioned working through other financial institutions. As will be explained below, this channel was not feasible due to trust and compliance issues.

As a result of these constraints, the disbursement of donor aid in terms of processing of proposals to recipient SMEs (through-put) was delayed. To exemplify this, the evaluation found that the number of deals proposed by the IDC never reached its targeted 300 proposals per annum, nor the revised downward target of 400 proposals over the duration of the four year implementation period of the RCF2.⁵⁸ Nonetheless, while there were disbursement problems at the beneficiary level, all EC funds for the two financing cycles of the RCF were fully disbursed. As will be discussed in the third evaluation question below,

⁵⁵Interview with Milly Chesire (Pretoria, May 2011).

⁵⁶ With the exception of the Niche Fund, which has marketed itself successfully.

⁵⁷See Evaluation Question 2 for examples.

⁵⁸ The evaluation was not able to compute the effective numbers of deals proposed through the Direct Channel, as the IDC does not maintain such statistics.

the reason for this was that the RCF generally attained most of its performance indicators. As the EC Project Officer pointed out, “The RCF is one of the highly performing EC programmes despite the delays in disbursement.”⁵⁹

The second indicator addressed by this evaluation question explored whether the RCF or the LED KZN facilitated a greater financial leverage effect of donor aid? The Commission made a binding promise to scale up development assistance at the Monterrey Conference in 2002, followed up by a Communication on this commitment (European Commission 2004). As outlined in the reconstructed program theory, financial leverage was one of the key objectives behind the Commission’s decision to channel its funds. It is about attracting additional funding to combine with the donor grant to achieve larger development objectives.

Based on data received by the implementing institutions, the RCF had a considerable impact in terms of financial leverage effect compared to the donor’s traditional aid modality.

Table 5.1: Direct Financial Leverage Effect: RCF vs. LED KZN

Assessment Area	RCF	LED KZN
<i>The intervention has leveraged development finance?</i>	Yes	Yes
What was the direct financial leverage effect (how much)?	529%	28%

Source: IDC (2011) and European Commission (2009a).

As Table 5.1 indicates, the LED KZN project leveraged 28% of the donor’s original ODA grant in terms of additional public and private sector funds, as well as through technical assistance. Comparatively, the RCF was structured so as to guarantee that the donor funds would be leveraged by at least 100%. This was ensured by the IDCs commitment to co-finance deals on the basis of a 50/50 commitment through the Direct and Niche Fund Channels. In fact, this target was far surpassed: the EIB estimates that by

⁵⁹ Interview with the RCF project officer, Milly Chesire (Pretoria, May 2011.) The project officer was responsible for overseeing the day-to-day management of the innovative RCF at the donor level.

September 2011, EC funds had been leveraged by 529%, clearly exceeding the target by a wide mark (EIB 2011). Most of this additional finance came in the form of venture capital via the Niche Fund Channel. Not only do these figures highlight the significantly larger leverage effect of innovative blending vis a vis traditional aid, but also the ability of this innovative aid modality to address certain constraints to private sector development. As will be discussed below, this involved crowding in investments from the IDC and the private sector by mitigating the risks associated with SME financing.

In terms of the various disbursement channels which comprised the RCF, while both the Direct and Niche Fund Channel have been a success, it must be stressed that the Third Party Channel was a failure. Based on interviews conducted with the RCF and a potential private third party investor, the reasons for its failure are three-fold.⁶⁰ First, the evaluation found that the RCF unit and the potential investors got into disagreements over the division of responsibilities. In several cases the private investor backed away once they were faced with the heavy due diligence exercises required by the RCF, especially with regard to the follow up of the investees' numerous socio-economic conditionalities. Furthermore, in one particular case, a private third party lending institution (Business Partners) complained about the delays incurred by the IDC in the deal making process, hence opting out of the process altogether.⁶¹ Second, interviews revealed that the failure was also a reflection of the limited incentive structure within the implementing institution to pursue this channel, given it represented the same amount of work as the IDCs direct lending without the benefit of promoting its own lending instruments.⁶² Lastly, the limited empowerment of RCF account officers meant that RCF staff was overly reliant on the IDCs throughput of deals. Furthermore, the unwillingness of the RCF staff to follow up on the third party investments demonstrated the weak empowerment of the RCF account officers.⁶³ Despite these problems, however, EC officials interviewed remain optimistic that in the future an agreement will be reached with another public investment institution in South Africa,

⁶⁰Interviews conducted with Siyabonga Mahlangu from the IDC and Nazeem Martin from Business Partners (Johannesburg, October 2011).

⁶¹Interview conducted with Nazeem Martin (Johannesburg, October 2011).

⁶²This issue was raised with one of the IDC sector departments, which was not interested to do a due diligence review of a third party proposed RCF operation, feeling it has no interest in the deal and therefore no motivation to do the due diligence required. Interview conducted with Kalvenie Raja from the IDC (Johannesburg, October 2011).

⁶³Based on interview conducted with Francois Xavier Parant in Cape Town (April 2011).

whereby investments will be channelled to investees via the Third Party Channel.

Finally, apart from absorptive capacity and financial leverage effect, the evaluation also explored whether the RCF or the LED KZN facilitated greater policy leverage. Policy leverage here is defined in the context of the donor's Private Sector Development strategy for South Africa which aims to reduce risks to private entry by providing public support. Indeed financial leverage was not the only and maybe not the most important leverage effect of the RCF. Interviews point to two forms of policy leverage facilitated by the RCF. First, EC funding itself facilitated the critical mass necessary for the SME support to take place in the first place. It therefore represents an added value per se. Second, EC channelling led to a crowding in effect of similar kind of funds targeted at SMEs within the IDC.

With regard to the first point, numerous interviews with the stakeholders involved consistently reflected the view that the presence of the Commission's grants provided the critical mass necessary for facilitating SME support to previously unbankable projects in the recipient country.⁶⁴ It therefore seems that the RCF filled a gap previously not covered by local DFIs or the commercial financial institutions in South Africa (who traditionally prefer senior secured lending and steered clear of high risk SME financing). This is backed up by a study by Foxcroft, Wood, Kew, Herrington, and Segal (2002) who reported that around the time of the launch of the RCF, 75% of new SMEs applying for bank credits in South Africa were rejected. Moreover, the IDC officials interviewed agreed that given their institution's risk averse nature to non-traditional markets, the IDC would not have engaged in this kind of lending without the EUR 108 million of EC funding in the first place. Consequently, by providing the IDC with EC grant finance, the RCF was structured in a way which enabled the use of a wide range of risky financial instruments which allowed for sizeable investments in a previously unbankable sector (mostly via subordinate unsecured loans).

With regard to the second policy leverage effect, the success of the RCF has facilitated a crowding in effect for SME financing worth ZAR 1.4 billion within the IDC itself.⁶⁵ According to one EIB interviewee, this crowding in can be seen as a cultural shift in the evolution of the IDC towards SME financing, which was initially not part of its mandate.⁶⁶ Indeed, following the success of this innovative facility, the IDC launched a number of

⁶⁴Interviews conducted over the course of two years (2010-2011). Please refer to the Bibliography for a complete list of persons interviewed.

⁶⁵At June 2011 exchange rates (the time of the evaluation) this represented approximately EUR 145 million.

⁶⁶Based on interview conducted with Francois Xavier Parant in Cape Town (April 2011).

similar facilities modelled on the RCF (see Figure 5.5).

Like the RCF, these funds also target un-bankable and risky enterprises with a development output. To give an example, the Isivande Fund is a ZAR 100 million facility dedicated to the support of small projects by women in the range of ZAR 20,000 to ZAR 5 million per investment. According to IDC sources, it was launched following the success of the RCF and was entrusted under the care of the RCF Strategic Business Unit, which proves the confidence that the IDC puts in the RCF delivery mechanisms.⁶⁷ What is more, the IDCs new funds are far less demanding in terms of development conditionalities, making project uptake easier.

Ultimately, the development of these similar funding programmes within the IDC demonstrates the crowding in effect facilitated by the RCF. Furthermore, the RCF introduced the culture of providing Business Support Services (BSS) which has now been mainstreamed in the IDC.⁶⁸ Based on these results, the RCF did not only facilitate financial leverage on EC grant money, but it also facilitated sector and policy leverage in the context of the donor's national development strategy.

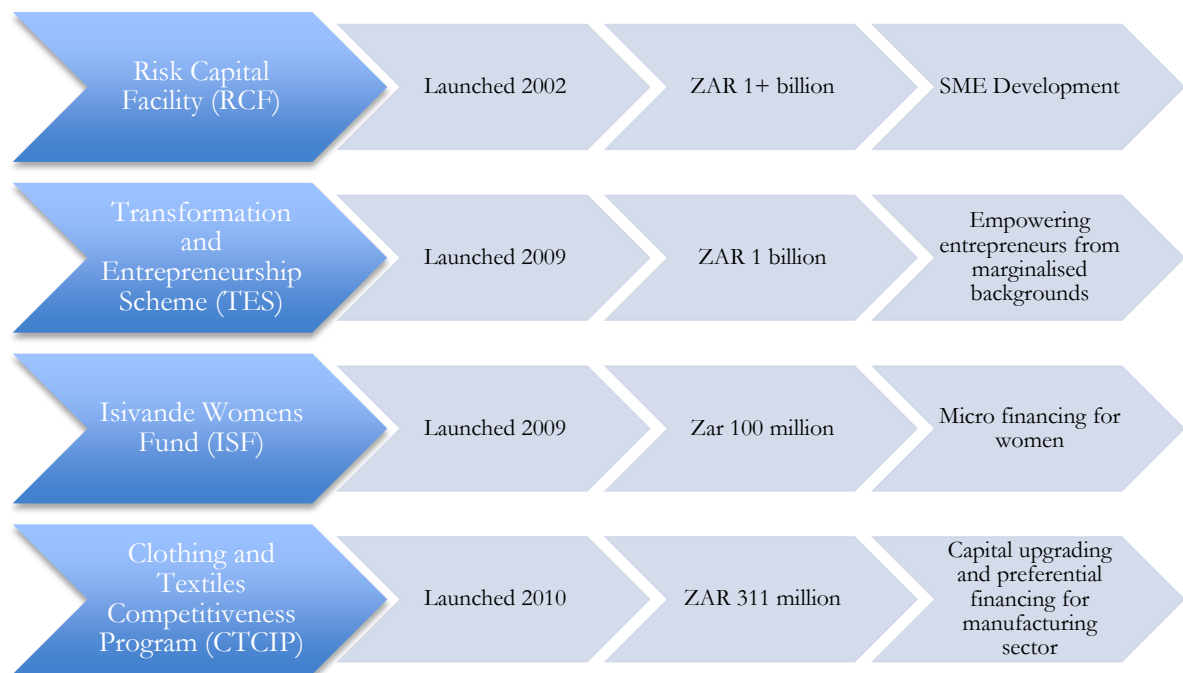
Comparatively, the traditional LED KZN exacted some policy leverage too. According to the LED KZN's programme manager, "The European Union's injection of some ZAR 400 million over the six years, along with the much needed technical expertise, gave the impetus to make the pursuit of local economic development possible in the first place." Furthermore, he went on to argue that "The very presence of the LED KZN programme has propelled the notion of local economic development onto the agenda of provincial and local governments in KwaZulu-Natal."⁶⁹ This assessment suggests that the LED KZN has raised the broader profile of the issue of local economic development, thus acting as both a catalyst and an agent for the cause of local economic development in the province. Unfortunately, however, the evaluation could not identify concrete evidence of the interviewee's assessment. Furthermore, in contradiction to the interviewee's comments, the survey results indicated that the EC representatives did not have a shared view on the interventions added value in terms of policy leverage, nor what it should have been.

⁶⁷Also noteworthy about the Isivande Fund is that it managed to receive a ZAR 50 million commitment from a private party, Old Mutual, alongside the DTI ZAR 50 million allocation. As such it succeeded in leveraging additional private finance to a previously disenfranchised segment of South Africa's SME sector.

⁶⁸Business Support Services did not exist in the IDC prior to the RCF. Since June 2007 BSS function was transferred to the whole IDC client base and located under Operations Head Office.

⁶⁹ Interview conducted with Steven Pienaar (Johannesburg, October 2011).

Figure 5.5: Crowding in IDC Funds - Overview of New IDC Funds



Source: IDC (2011).

Ultimately, despite minor problems related to the absorptive capacity of the RCF, the evaluation found that the RCF provided the donor with substantial value for money in terms of financial and policy leverage. Here the country presence and thematic expertise of the IDC in the area of private sector lending played a key role. The RCF has a substantially higher financial leverage effect than the traditional LED KZN (529% compared to 28%). In terms of policy leverage, the RCF provided the catalyst for this funding to take place in the first place and subsequently crowded in SME support by the IDC (ZAR 1.4 billion). By doing so the RCF acted as a market-correcting element, allowing certain constraints to private sector development to be addressed. Despite these findings, however, it is important to underline the fact that loans, such as the ones made available by the RCF, are by nature debt obligations and need to be linked to revenues capable to recover the loan capital and interests. Hence they should be seen as a complementary tool to traditional grant based assistance. While this new form of aid delivery is clearly a highly effective instrument for the donor in terms of financial and policy leverage, there is a justified fear that necessary grant

assistance is reduced under the justification that blending instruments expand development aid at lower cost to the donor.

5.22 Coherence of Development Objectives and Capacity to follow Up on Results

Evaluation Question 2: Did the donor ensure coherence of development objectives pursued and was he capable of following up on results when providing grant finance to the RCF? How did this compare to the provision of the EU's global PSD financing?

An important element of demonstrating VfM in the provision of aid lies with evaluating the effectiveness of the process. Consequently this evaluation looks at the coherence of objectives between the donor and the implementing institutions and the donor's ability to follow up on development results. With regard to the reconstructed program theory, this question corresponds to the results and outcomes level, addressing issues of *effectiveness and sustainability*.

With a view to exploring the coherence of the donors development objectives, this evaluation question first explored to what extent the objectives of the donor were in line with those pursued by the implementing institutions. According to Commission sources, the EC was able to ensure consistency between its own objectives and the objectives of the recipient. The reasons for this were threefold. First, the donor was fully involved during the set up of the innovative RCF. Second, the donor used specific targets in the form of pre-defined development results. This included earmarking its contribution to specific activities in a specific sector. In this case it earmarked the funds for Risk Capital in the SME sector, making sure that the use of the donor money was aligned with the strategies and priorities of its Private Sector Development Strategy. Third, the donor aligned its Private Sector Development Strategy with the South African government's development strategy. The main objective of the donor's strategy is thus to assist South Africa with employment generation in the SME sector, as outlined in the government's economic development policy (DTI 1995).

The joint objectives and results pursued with the financing of the RCF were subsequently laid out in the Financing Agreement. The FA was a binding contract between

the South African government and the EC confirming their joint agreement to the objectives of the RCF.⁷⁰ The justification for the FA and the objectives outlined in it was given in the preparatory documents and agreements, notably the feasibility study. The feasibility study is conducted in the formulation phase of the programme. The study highlighted that the donor wished to establish a dynamic partnership with an appropriate apex institution (i.e. the institution to act as the implementing agency) already active in the SME sector which is a parastatal organisation and has a strong business culture. On this basis, the feasibility study proposed the IDC as the best parastatal for this purpose, primarily due to its strong development finance track record in South Africa. However, this recommendation could also possibly have been directed by the South African government as it is indicated in the feasibility study.⁷¹

Traditionally DFIs provide development finance to address market failures and so complement both government sources and market financing, as well as broader development policy objectives including the governments strategic growth plan. The IDC was set up to promote economic growth and industrial development. It provides finance for industrial development in South Africa and the Rest of Africa. Moreover, about 97% of new investment approvals in the IDC's priority sectors are identified in the government's New Growth Path (IDC 2012).⁷²

As per the Financing Agreement, the EC and IDC decided that the RCF would support the empowerment of HDPs through SME equity support.⁷³ With regard to the first RCF financing cycle (RCF1), the pre-defined development objectives included the following:

- 1) **SME Support:** Enhanced access to finance for SMEs and emerging entrepreneurs via the EUR 58 million grant through investments as equity or quasi-equity;
- 2) **Job Creation:** RCF1 should create new jobs,⁷⁴ with a focus on HDP women;

⁷⁰For the RCF2, this support took place in alignment with the DTT's Medium Term Strategy Framework for 2005 to 2008 of contributing to a higher level of economic growth, creating employment and reducing levels of inequality in the economy.

⁷¹Article 7.2 of organisation and implementation procedure in the RCF1 feasibility study.

⁷²The New Growth Path, adopted in 2010, is the South African government's framework for economic policy and its job creation strategy.

⁷³As outlined in South Africa's Broad Based Black Economic Empowerment (BBBEE) act.

⁷⁴The financing agreement does not stipulate the nature of the jobs, i.e. full-time or part-time.

- 3) **HDP Empowerment:** RCF1 should facilitate the transfer of technical, financial and management skills to members of historically disadvantaged communities;
- 4) **Financial Self-Sustainability:** RCF1 should be revolving and self-sustainable.

At the time when these targets were set, SMEs contributed 56% of private sector employment and 36% of the GDP (Ntsika Enterprise Promotion Agency 2002). With a view to addressing unemployment, income inequality and poverty in South Africa, promoting small business development via the RCF was therefore a highly sensible approach.

For the second RCF financing cycle (RCF2), the *sui generis* approach was replaced with more specific and measurable performance targets. On the basis of recommendations following a review of the RCF1, the financing agreement for RCF2 laid out seven pre-defined results and their related indicators:⁷⁵

- 1) **SME Support:** Approximately 70 SMEs should be funded from the EUR 50 million grant through investments as equity or quasi-equity. Simultaneously the investees would benefit from a business support services programme funded by a EUR 5 million grant;
- 2) **Job Creation:** The RCF2 should create 6000 new jobs, of which 30% are to be held by women;
- 3) **Financial Self-Sustainability:** RCF2 should be revolving and self-sustainable;
- 4) **HDP Empowerment:** The investee will have to achieve a 25.1% HDP ownership within one year from investment. It was also envisaged to achieve women empowerment through shareholding and possible access to management positions;⁷⁶
- 5) **Business Support Services:** Access and use of BSS should be implemented to improve effective assistance to SMEs;
- 6) **Environmental and HIV Awareness:** Investees shall set up an environment and HIV/AIDS protection plan in accordance with the South African law;
- 7) **SME Support for Wider Africa:** Fifteen investments shall involve SMEs active in the rest of Africa, to provide a minimum of 500 jobs.

⁷⁵These were developed between the DTI, EIB and IDC on the basis of work/experience from the RCF1 phase, taking into account of, inter alia, desired portfolio characteristics, and desired development objective in line with EC PSD strategy.

⁷⁶HDP shareholder is either: a. HDP Individual; b. In the case of a workers trust – number of HDP individuals participating in the shareholding; c. An entity that has 25+1 HDP shareholding (counted as 1 shareholder). Management implies supervisor status and upwards, i.e. in charge of more than one person in a function.

Although these seven indicators ensure that the donor grant money would be used for development purposes, one IDC interviewee argued that some of the criteria were too rigid and led to delays in the implementation of the facility. The interviewee mentioned that “While some conditionalities were eventually relaxed, this took a long time, thus not allowing the IDC to adapt quickly to the market needs.”⁷⁷

When confronted with this issue, the EC project officer explained that this was a result of the innovative nature of the risk capital financing and the inherent lack of documented guidelines available for decision makers at the donor level.⁷⁸ Furthermore, interviews at the donor’s headquarters in Brussels suggested that although the EC has increased its focus and financing for blending related activities over the last couple of years due to a growing demand for catalytic aid, this has taken place largely on an ad hoc basis rather than as a clearly defined development strategy.⁷⁹ This finding suggests that the EC needs to explicitly define its strategy when channelling aid to blending activities so as to ensure that the decisions to fund blending activities are motivated and based on formal guidance criteria. This includes specifying the objectives, characteristics and rules of EC blending.

With regard to the European Investment Bank, coherence was streamlined since both institutions adhere to the development policy objectives defined in the European Consensus for Development and the EU Treaty. This was supported by EIB and EC officials interviewed, who reported that the two institutions are aligned on the objectives of development in general. What is more, the two institutions signed an EC-EIB Memorandum of Understanding (MOU) regarding technical assistance for the Programme. Consequently both partners pursued common objectives and results.

Finally, when compared to the EU’s global PSD activities, the donor generally aligned its support with the national priorities with recipient countries (ADE 2013 p. 37). This was partially attributed to the Paris and Accra Declarations, which stipulate that donors should provide aid which is in synergy with national development strategies. While in some cases the EU did not align due to a lack of a national strategy in a recipient country, these were the exception. Consequently, in terms of coherence of objectives, the implementation of this

⁷⁷ Interview conducted with Jorge Maia (Johannesburg, May 2011).

⁷⁸ Interview conducted with Milly Chesire (Pretoria, May 2011).

⁷⁹ Interview conducted with Hannes Bahrenburg (Brussels, July 2011).

innovative aid modality generally followed the global guidelines pursued by the donor for all of its aid interventions.

The second element which this evaluation question addressed surrounded the ability of the donor to follow up on its grant financing. Here the evaluation explored the capacity of the donor to monitor the grant financing channelled to the innovative facility compared to its traditional aid interventions. The EC provided EUR 58.901 million for RCF1 and EUR 50 million for RCF2. According to the EC Delegation staff interviewed, the EC has the capacity and manpower to follow up the use of these funds. At the Delegation level, there were three people involved with the RCF: (1) a Project Officer/Task Manager, who maintained a close relationship with the Programme involving following up on implementation, including attending Programme Steering Committee meetings on a quarterly basis; (2) a Head of Section who oversaw the Project Officer; and (3) the Head of Development Cooperation who oversaw the overall implementation of EC development aid in South Africa. Additionally there was also the Head of Finance and Contracts and subordinates who oversee all contractual issues (although their relationship to the Programme is a bit more distant).

The key person at this level, however, was the Project Officer, who was responsible for the day-to-day management of the facility. The responsibilities of this person include following up on critical issues pertaining to the RCF on a timely basis, as well as coordinating with the relevant structures within the Commission. As part of this set up, the EIB technical assistant is instrumental in providing technical advice to the EC Project Officer, especially on how to address challenging issues.⁸⁰

At the donor headquarters level, the Results Oriented Monitoring (ROM) unit was responsible for following up on the RCF performance.⁸¹ As part of the EC's Project Cycle Management (PCM) guidelines, the ROM unit was responsible for conducting the evaluation and monitoring phase, which are a precondition for the release of subsequent grant finance. The EC commissioned a Medium Term Review (MTR) for RCF1 and RCF2 respectively in September 2003 and October 2009, with the results being communicated to EC headquarters in Brussels. For the RCF2, the MTR was a precondition justifying the payment

⁸⁰ Evidence of interactions (notes, meetings, etc.) can be found in quarterly and annual reports since 2007.

⁸¹ There is also a specific unit dedicated to Financing Instruments under the DG DEVCO. However they deal with the matter on a thematic level.

of the third tranche (EUR 13.5 million). That being said, while the reporting was available to task managers, interviews at EC headquarters in Brussels revealed that databases and information systems on blending mechanisms were and still are confronted with structural issues: they are not homogenous and there is no archive or database for providing overviews of the EUs global blending instruments. As a result EC staff has difficulties with the retrieval of adequate information on blending mechanisms.

When compared to the donor's global PSD interventions between 2004 and 2010, the follow up and monitoring of final impacts was also problematic. Whereas most PSD interventions reported successful completion of outputs, the subsequent impacts were often not monitored by the donor. This was particularly true for interventions that provided tailor made investment related activities, including supporting SMEs via intermediary organisations (ADE 2013 p. 97). Here evaluations commissioned by the donor faced difficulties with regards to a lack of baseline data, as well as uncertainty as to what should be measured. This was thus consistent with the evaluation's findings related to the RCF. Consequently while the organisational structure at EC headquarters for blending mechanisms has not been sufficiently developed, the follow up and monitoring of results and impacts was equally problematic for the donor's traditional aid interventions.

Finally, at the IDC level the evaluation found that the managers at the implementing level communicated well and demonstrated effective transmission of the agreed monitoring documents. Furthermore, the EC project officer also noted that detailed monitoring reports were prepared by the IDC on a quarterly and annual basis. These reports demonstrate the evolution of the RCF unit to date and have provided assurance of the IDC's professionalism in managing the RCF. In addition, the EIB made presentations during the PSC meetings which demonstrate the quarterly and annual progress, and also prepared annual performance reviews reports reflecting on the IDC's management of the innovative facility.

Ultimately the results presented above suggest that the EC generally ensured that its own objectives and those of the recipients were in line. While some of the RCF's conditionalities proved overly rigid this was a result of the innovative nature of the risk capital financing and the inherent lack of documented guidelines available for decision makers at the donor level. Furthermore, the evaluation demonstrated that at the implementing level, the donor had the capacity and manpower to follow up the use of these innovative funds. Here the IDC and the EC Delegation were supported by the EIB. Yet while the RCF reported successful

completion of its outputs, the donor did not monitor the impacts. Moreover, evidence suggests that the follow up and monitoring of results and impacts was equally problematic for the donor's traditional aid interventions.

5.23 Development Results Achieved

Evaluation Question 3: To what degree did channelling to this innovative facility contribute in a sustainable manner to achieving the intervention objectives the donor targeted when channelling its funds? How do the results compare to broader SME support in South Africa as well as the EU's global PSD financing?

The first objective of this evaluation question is to determine if the RCF achieved its own financing targets and to locate these financing efforts in the broader context of SME support in South Africa. Here the case study compares RCF support in the context of the IDC's global lending portfolio as well as with data on financing extended to SMEs by other DFIs in South Africa, including private sector SME lenders. The second objective is to compare the RCF financing results to the EU's global PSD financing results where possible.⁸²

With regard to the reconstructed program theory, this question corresponds to the results and outputs level, addressing issues of effectiveness, impact and sustainability. Indeed, this evaluation question is important in terms of measuring VfM as the degree of achievement of the results and impacts at the beneficiary level is the ultimate justification for providing development aid.

The findings presented below are grounded in the data, interviews and reports facilitated by a number of institutions and companies.⁸³ The results will be presented in accordance with the core themes of the private sector support provided by the innovative RCF and compared to broader SME support in South Africa as well as the EU's global PSD financing where possible. This includes first, SME support, and second, job creation and socio-

⁸²This was deemed as appropriate since the LED KZN did not serve as counterfactual with regard to the ultimate beneficiaries, providing no comparable control group to measure against the RCF.

⁸³ Including the IDC, EC, EIB, the Small Enterprise Financing Agency (SEFA), Business Partners, and the DTI.

economic support.⁸⁴ Additionally the evaluation will explore the financial self-sustainability of the blending facility financed and provide an in depth analysis of two investee clients funded by the RCF to demonstrate some of the benefits and constraints of the intervention at the micro level.

First, with regard to SME support, access to finance is a key constraint for private sector development in developing countries. As Table 5.2 indicates, the RCF is not the only provider of SME financing in South Africa.⁸⁵ Here the evaluation tried to compare the RCF's performance indicators to global IDC lending as well as broader SME support where possible.

At the time of its inception, the RCF was unique in its targeting SMEs which were previously considered to be unbankable.⁸⁶ Indeed, at the beginning of the first RCF financing cycle in 2002, the Small Enterprise Finance Agency (SEFA) had not yet been launched (this was only the case in 2012).⁸⁷ SEFA, a subsidiary of the IDC, covers a large portion of the SME market, including micro-enterprises with a HDP focus. While the IDC's global lending activities also offers SME financing, it focuses more on the medium segment of the SME market (IDC 2012). Similarly, Business Partners, a specialist risk finance company, provides financing to SMEs with a lower risk valuation than the RCF.

Table 5.2 RCF Indicators in context of broader SME Support

	RCF1	RCF2	SEFA	IDC Global Lending	Business Partners
SME financing	Yes	Yes	Yes	Yes	Yes
Focal sector	Agribusiness	Agribusiness	Service	Metals and Mining	Service
Cost per job	n/a	ZAR 41,800	ZAR 48,031	n/a	ZAR 10,001
HDP focus	Yes	Yes	Yes	No	No
Investment in rural areas	n/a	63%	67%	48%	50%

⁸⁴While the RCF1 did not have predefined results, the financing agreement for RCF2 laid out seven pre-defined results and related indicators formulated on the basis of the experiences with the RCF1.

⁸⁵ The evaluation was not able to find comparative data for all of the indicators in table 5.2 (n/a indicates that data was not available).

⁸⁶ Eligible SMEs require any two of: Less than 200 employees; Annual turnover of less than ZAR 51 million; Total assets of less than ZAR 55 million.

⁸⁷ SEFA was established on 1st April 2012 as a result of the merger of South African Micro Apex Fund, Khula Enterprise Finance Ltd and the small business activities of IDC.

B-BBEE focus	Yes	Yes	Yes	Yes	Yes
Women ownership	17%	40%	39%	4%	n/a
Women jobs	n/a	33%	n/a	n/a	n/a
Women management	n/a	37%	n/a	n/a	n/a
Business Support	No	Yes	Yes	Yes	Yes
Environmental and HIV support	No	Yes	No	Yes	No
SME support for wider Africa	No	0	No	No	No
Financial self-sustainability	No	No	Yes	Yes	Yes
Impairments	n/a	31%	30%	18.2%	6.8%

Source: (EIB 2011, SEFA 2013, 2014, IDC 2011a, 2012, Business Partners 2012)

With the creation of the RCF1 over 64 SME's gained access to support, which, according to IDC officials interviewed, would not have been able to access finance otherwise.⁸⁸ These initial results indicated the RCF's ability to reconcile social welfare support through grants and commercial sector support; something the donor could not have done via its traditional aid modalities.

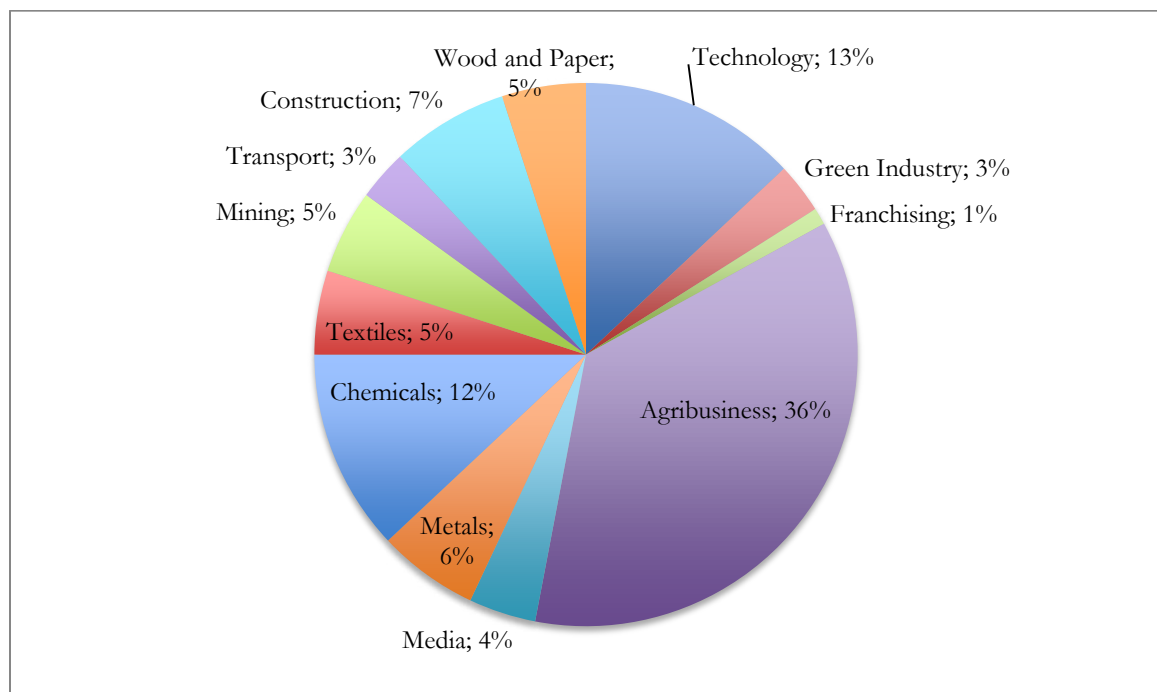
Following the positive experiences with the RCF1, the second financing cycle included a target of supporting at least 70 SMEs through its three investment channels. After some delay in the implementation of RCF2, by August 2011, 47 investments worth ZAR 295 million had been approved through the Direct channel and Niche fund channel (IDC 2011). While the target number of 70 SMEs had not been reached, this should be seen in the context of the aftermath of the financial crisis in 2008, which brought about a general reluctance of SMEs to borrow due to uncertainty regarding the economic recovery. Despite these uncertain times, however, one interviewee highlighted that in contrast to traditional lenders, the RCF did not cut credit lines nor tighten its lending criteria.⁸⁹ Ultimately, at the time of the evaluation EIB and IDC staff were optimistic that the facility would meet its targeted amount before the culmination of the programme.

⁸⁸ Interview conducted with Jorge Maia from the IDC (Johannesburg, October 2011).

⁸⁹ Interview conducted with Jorge Maia (Johannesburg, May 2011).

With regard to the sector distribution, Figure 5.6 demonstrates the RCF's high level of investment in the agribusiness sector (nearly half of commitments). This is unusual when compared to the investment focus of the broader SME support in South Africa (see Table 5.2). Business Partners, for instance, primarily finances SMEs operating in the service sector (36%), while agribusiness accounted for an insignificant amount of its lending (Business Partners 2011). What is more, according to IDC figures, agriculture and forestry accounts for only 3,9% of its global lending portfolio, while the metals and mining sectors dominate the portfolio with 20% and 23% respectively (IDC 2011a). Despite this relative concentration, the IDC has made significant progress in diversifying its portfolio from resources to non-resource-based investments (IDC 2012).

Figure 5.6: RCF2 Sector Distribution by Loan Volume



Source: EIB (2011).

With regard to the RCF, it thus seems that the SME sector to which it caters is characterised by a high level of agricultural related business ventures. While this concentration of risk could have an effect on fund viability, it was noted by IDC staff that this sector is desirable from a development perspective given agribusiness has the potential

to create knock on effects by promoting other local suppliers.⁹⁰ That being said, the largest investee's in this sector need to be managed closely as any negative performance will significantly impact the fund growth/sustainability. Diversifying its portfolio would limit the RCF's exposure to factors beyond its control, such as market and labour volatility, while improving its ability to exercise its developmental mandate.

In addition to support for the local SME industry in South Africa, the RCF's Financing Agreement also outlined that 15 SMEs involved with operations in all of Africa should be supported by the RCF2, providing at least 500 jobs. As Table 5.2 indicates, this was an ambitious target even when compared to the broader SME support in South Africa. Not surprisingly, this target has been a failure, as no such investment has been committed so far. Nonetheless, it must be noted that it is the opinion of the EIB staff interviewed that such a result is not achievable in the present environment, as HDP SMEs are generally too weak on the management side to extend themselves internationally.⁹¹ This suggests a general failure on part of the EC's strategy documentation, given that a needs analysis prior to the RCF's implementation was only conducted on an ad hoc basis.

Table 5.3 Comparative Indicators RCF and Global PSD Support

	RCF	EU Global PSD
SME Support	Evidence of improved access to finance for SMEs	Little evidence of improved access to finance for SMEs
Business Support	Business support was provided under the RCF2	Technical assistance made up the largest share of global PSD support
Job Creation	Evidence of job creation	Linkages between EU support and job creation remained distant at best
Development Conditionalities	Rigid lending conditionalities tied to development targets	Evidence of stringent development conditionalities

Improved access to financing for SMEs was also one of the targets laid out in the European Commission's Guidelines for PSD support (European Commission 2003a p. 11). Notwithstanding this target, the donor's global PSD support demonstrated little evidence of improved access to finance for SMEs between 2004 and 2010. Based on an ADE (2013)

⁹⁰Interview conducted with Meryl Mamathuba (Pretoria, May 2011).

⁹¹Interview conducted with Francois Xavier Parant (Cape Town, April 2011).

evaluation, the Commission's activities primarily supported beneficiaries at the macro level, with very limited support for SME credit lines at the micro level. The report notes that:

Of the 20 EU Delegations responding to the EU Delegation survey that conducted access to finance activities, 65% (13) conducted activities aiming to improve the regulatory environment of financial intermediaries and 80% (16) conducted activities supporting intermediary organization. Indeed, very few PSD interventions acted at the micro-level, barring some cases of projects aiming to enhance enterprise ability to access finance (e.g. in Jordan). (ADE 2013 p. 130)

The report further suggests that in the few instances where access to finance was a project objective, a lack of analysis and private sector consultation prior to project implementation led to considerable problems in terms of SME financing. These findings seem to suggest that in comparison the innovative RCF demonstrated far greater value.

In addition to SME financing, the innovative blending facility also provided business support services to its recipients. While there was no Business Support for the RCF1, the EIB pushed for it as a necessary addition for RCF2. As a result, the IDC provided a EUR 5 million grant for the provision of Business Support Access under RCF2. Consequently the financing agreement stipulates that this support must be used to improve effective assistance to SMEs either on an *ex ante* basis to improve feasibility studies or business plans of the investees, or on a *ex post* basis to support management in a number of domains such as finance or marketing.

In the case of the RCF financed projects, BSS has had a low uptake. By August 2011, there had been 13 approvals worth ZAR 11.04 million in commitments (IDC 2011). Yet actual BSS disbursements stand at a low ZAR 220,780, including some grants paid to RCF1 clients. This figure represents only a fraction (0.4%) of the total budget of EUR 5 million (ZAR 48.5 million) available for RCF investees.

According to EIB sources, the main reason for the lack of use of BSS was related to the fact that the RCF provides its funding predominantly through subordinate unsecured loans. By not supporting the investees as a minority shareholder, the RCF does not provide support to the SME management, neither at the board level, nor at the executive management level. This "lender" approach and the non-compulsory nature of this support

provides no incentive to support the investees via BSS. Additionally, as will be discussed in evaluation question five, IDC management fees are set up in a way that prompts RCF task managers to maximize re-flows i.e. select good risks. As a result some of the projects financed by the RCF are not strictly “unbankable” and do not require BSS. Finally, it was also noted that there has been a lack of cooperation between the Business Support Services and the RCF Strategic Business Unit within the IDC.

When comparing these results to broader SME support in South Africa, Table 5.2 indicates that business support is general industry practice. SEFA, for instance, focuses on post investment support to manage the rate of impairments. As noted in their annual report:

A post investment unit is now pro-actively providing business support and tailored mentorship services to SMME clients. Partnerships with private sector service providers have been established to provide tailored and industry specific business support and mentorship programmes, aided by effective workout and restructuring interventions (SEFA 2014 p. 30).

Perhaps more significantly, business support via non-investment support (i.e. technical assistance) made up the largest share of global PSD assistance between 2004 and 2010 (see Table 5.3). While this sort of support was made available over a wide range of countries and a diverse range of aid modalities, the majority of it targeted the institutional and regulatory level with a view to building capacities at intermediary institutions (ADE 2013 p. 100). Furthermore, evidence suggests this type of support improved the institutional capacity of intermediary organisations without necessarily improving business support for enterprises. While there are thus parallels to the experiences with the RCF, blending facilities have the potential to significantly extend the availability of technical support at the micro level compared to traditional interventions.

In addition to SME support, the evaluation explored the job creation and socio-economic support results. When compared to its own targets, the RCF has been very successful at creating jobs. While the first round of financing did not involve explicit targets, for the RCF2 the job creating target was set at 6,000, with jobs created through the Direct Investment Channel not exceeding the cost per job ratio of ZAR 60,000 for a portfolio basis. By August 2011, the time of the last available figures, the RCF had created an

estimated 5,395 jobs through the direct investment channel and the niche fund channel, and was therefore well on track for reaching its target. The average cost per job stood at ZAR 41,800 per job created and is therefore also well below the target of ZAR 60,000 (EIB 2011).⁹²

In comparison, Table 5.2 indicates that the private SME lender Business Partners' cost per job created was much lower, standing at around ZAR 10,001. Interestingly the average cost per job created by SEFA stood at ZAR 48,000 (SEFA, 2013). Given SEFA also has a HDP focus along with socioeconomic empowerment conditionalities, this dynamic seems to support the notion that the RCFs cost per job ration was aligned with its role in supporting high-risk sectors and businesses unattractive to commercial financiers.

That being said, it is important to mention two caveats, notably the nature of the jobs created and the distribution across SMEs financed by the RCF. First, while there is no explicit mention of the nature of jobs to be created in the financing agreement signed between the donor and the IDC, the evaluation revealed that in some cases jobs created included part-time employment. This was particularly true in the agribusiness sector which represented the majority of RCF investments and which is characterised by seasonal employment. Second, the distribution of jobs created among the SMEs financed was skewed. Here the evaluation discovered that the six largest investees alone contribute to more than 50% of the expected jobs created and over 75% of expected HDP ownership. While some investees created a lot more jobs than others, this may be explained by the fact that many of the largest investees were active in the agribusiness sector. It thus seems that many of these jobs were of a seasonal nature.

When comparing these results to those of the EU's global PSD initiatives, this was no easy task, predominantly due to the fact that the EU's global PSD initiatives rarely included explicit targets and indicators to measure (see Table 5.3). Indeed, the RCF is one of the few cases involving pro-active targeting and monitoring of employment related objectives. Conversely the evaluation found that for the EU's global PSD interventions the linkages between EU support and job creation remained distant at best (ADE 2013). Interviews at the donor headquarters suggested that the EU's PSD support lacked a systematic approach

⁹²Taking the total RCF investment for a SME project and dividing it by the number of jobs created measured the total cost per job.

to integrating job creation as a key objective in aid modalities.⁹³ Rather the donor often treated job creation as a separate objective from PSD support. Furthermore, while job creation did figure in several intervention objectives, it was rarely monitored. The RCF's ability to push job creation in a previously disenfranchised sector was thus an effective tool at the micro level to create sustainable jobs in the context of PSD.

In addition to job creation, the RCF also provided support for a variety of socio-economic empowerment indicators (see Table 5.2). Based on the results obtained, the first financing cycles of the RCF led to the support for a significant number of HDPs. However, given there were no explicit targets for the RCF1, the results served primarily as a basis to formulate specific and measurable targets for the RCF2. To give an example, the figure of 17% of female shareholding under RCF1 indicated that more needed to be done with a view to targeting women empowerment. Consequently, the target for the RCF2 was set at 30%.

For the RCF2, socio-economic empowerment targets were pre-defined in the financing agreement between the donor and the recipient and largely benchmarked against the performance of the RCF1. This agreement envisioned increased HDP ownership at the SME level of a minimum of 25%+1 within one year from investment. According to EIB statistics, all but two transactions fulfilled this demand.⁹⁴ While these are positive figures, it should be pointed out that 75% of all HDP ownership was made up by the six biggest projects financed by the RCF. This is consistent with the finding presented above, which demonstrated that the six largest SMEs funded were also responsible for a disproportional share of job creation.

With regard to women empowerment, EIB statistics show that the target of 30% ownership, jobs, and management positions held by women have all been surpassed. In comparison, Table 5.2 demonstrates that SEFA also monitored women ownership as one of its financing targets. Of the SMEs financed by SEFA, 39% were women owned compared to the RCF's 40%. In comparison, only 4% of the transactions financed by the IDC's global lending activities were at least 30% women owned.

A similar comparison can be drawn in terms of geographical bias. The RCF2 financing targets stipulated that at least 65% of investments should be made outside the economic hubs of the Western Cape and Gauteng. The RCF is close to its geographical spread target

⁹³Interview conducted with Torsten Ewerbeck (Brussels, July 2011).

⁹⁴The same results were found by an independent review in 2009 (CHIKONAS 2009).

of 65% of investees outside the richest regions of Gauteng and the Western Cape (achievement was 63% in terms of volume). In comparison, 45% of IDC's global lending activities took place outside the two economic hubs, while SEFA's rural investments stood at 67% and Business Partners' at 50%. The RCF's focus on regional inequality within the SME sector was therefore an attempt at reducing the divide between the richest and poorest provinces of South Africa.

Finally, the last socio-economic target set out by the financing agreement stipulates that all RCF investees must set up an environmental and HIV/AIDS protection plan in accordance with the South African law. While this is a sensible approach in theory, it was difficult for SMEs to implement in practice. According to 2010/2011 IDC monitoring reports, not all investees have such policies in place. In fact, only six larger investees have HIV/AIDS policies in place, while the majority of smaller investees have no formal policies. Furthermore, although HIV/ AIDS may be informally discussed amongst investee staff, thereby raising awareness on these issues, the investee does not drive these measures.

With regard to environmental policies, all the investees adhere to environmental guidelines. That being said, two investees have experienced delays due to environmental certification. While the RCF should investigate the viability of co-funding HIV/AIDS policy development as well as environmental certification exercises, on the whole, the relevance of these conditionalities has to be questioned. Given most investees simply cannot afford implementing these measures, they represent an obstacle to the efficient implementation of the RCF.⁹⁵

Indeed, whether the amount of socio-economic conditionalities imposed was adequate is debatable. While some form of development oriented targets were necessary, the sheer number was excessive, leading to hold ups and a slow throughput of lending activities. This was made all the more evident when compared to the performance indicators of Business Partners, which was not constrained by these lending conditionalities (see Table 5.2). Interestingly, however, the rigidity of the RCFs lending conditions also played a role in facilitating the crowding in of additional lending activities within the IDC, as it led to the creation of similar funds within the IDC with less stringent lending conditionalities.⁹⁶

When compared to the donors traditional aid modalities, Table 5.3 indicated that global

⁹⁵See case study example for 'Cement Company Y' below.

⁹⁶As discussed in the first evaluation question.

private sector development support generally involved stringent development conditionalities (ADE 2013 p. 87). Despite stringent indicators, however, the EU's 2010 guideline highlighted the importance of improving PSD evaluations by providing much more concrete guidance to implementing institutions (European Commission 2010a). This lack of concrete guidance in the early stages of aid implementation was mirrored by the experiences with the RCF. Given the lack of formal guidance on blending instruments, EU officials involved in drafting the RCF's lending criteria chose to err on the side of caution, imposing a sizable number of socio-economic conditionalities. The implication is that in the future the donor needs to explicitly define its strategy when channelling aid to blending mechanisms so as to ensure that the decisions to fund this innovative aid modality are motivated and based on formal guidance criteria. This includes specifying the objectives, characteristics and rules of EC blending, and should be simple and flexible enough to deal with the market realities and dynamics of the private sector.

In addition to the results presented above, one of the key objectives predefined by the donor was for the RCF to maintain its nominal value over time, which means a nominal Internal Rate of Return of zero percent post bad debts and fund management fees. As Table 5.2 highlighted, at the time of the evaluation, the RCF was not yet financially self-sustainable. Establishing whether innovative blending facilities may in fact achieve financial self-sustainability is relevant to the evaluation question as it would demonstrate significant value vis a vis traditional project aid. Indeed, in the case of the EU's traditional aid delivery, projects often cease to exist once donor funding runs out.

Whether the targeted 100% sustainability ratio of the innovative blending facility may in fact be achieved at the end of the twelve-year implementation period depends on the future Internal Rate of Return (IRR) flows. While the RCF1 has not been revolving thus far, this has been attributed to the slow-through put of the new requests channelled to the RCF. That being said, EIB sources suggested that it is possible to calculate the viability of the fund on the basis of actual data and a number of assumptions.⁹⁷ Consequently, an analysis of the future receivables indicates that the RCF will be sustainable by the end of its implementation. Table 5.4 below provides an overview of actual and forecasted portfolio data for the RCF1.

⁹⁷See Appendix E for assumptions and a comprehensive overview of the RCF portfolio.

Table 5.4: RCF Portfolio June 30th 2011 (ZAR million)

Direct and Niche Fund Channel	Portfolio
Number of transactions approved (net of cancellation)	64
Committed Funding (actual + forecasted)	ZAR 277 million
Actual Disbursements	ZAR 269,4 million
Write offs	31%
Actual and Forecasted Reflows	ZAR 461,5 million
Actual and Forecasted Leakages	ZAR 119,8 million
Nominal IRR	3.4%

Source: IDC (2011).

As the table indicates, based on actual and forecasted reflows and leakages, the nominal IRR calculated on the current portfolio demonstrates a return of 3.4% (1.0% for the direct investment channel and 10.6% for the niche fund channel). The relatively low return on the direct fund channel is a result of the kind of high risk projects it facilitates. The high return on niche fund investments explains why this investment channel was able to attract considerable private capital. Overall the portfolio review suggests that the RCF1 will reach its targeted 100% nominal sustainability.⁹⁸

Like the RCF1, the RCF2 has not been revolving thus far, however was predicted to reach 100% financial sustainability at the end of its implementation phase. Based on the same assumptions as for the RCF1, Table 5.5 provides an overview of the actual and forecasted financial performance of the RCF2.⁹⁹

Based on actual and forecasted reflows and leakages, the nominal IRR calculated on the current portfolio indicates a return of 7.5% (4.2% for the direct investment channel and 11.7% for the niche fund channel), suggesting that the RCF2 will reach its targeted 100% nominal sustainability. RCF write-offs also represent a small proportion of the overall portfolio (13% for RCF2).

Referring to Table 5.2, the RCF's level of impairments (36% for RCF2) is relatively high

⁹⁸It should also be noted that an additional buffer to achieve the targeted nominal return can be derived from the fact that some re-flows are deposited on a interest bearing account, which might contribute to achieve the nominal sustainability, if not reinvested as planned.

⁹⁹As it stands, the Direct Channel and the Niche Fund Channel have been the only channels used under the RCF2, as still no investment has been realised under the Third Party Channel.

when compared to the broader support for SMEs in South Africa. SEFA, which also finances SMEs with an HDP focus, has an investee impairment level of 30%, while the IDC's global loan impairments stands at 18.2%.¹⁰⁰ The IDC's level of impairments has increased steadily over the past years, with the ratio of impairments as a percentage of the portfolio rising from 16.3% in March 2010 to 18.2% in March 2012. While this reflects the IDC's growing appetite for risk, the IDC's balance sheet continues to be dominated by large, mature, listed investments.

Table 5.5: RCF2 Portfolio September 30th 2011 (ZAR million)

Direct and Niche Fund Channel	Portfolio
Number of transactions approved (net of cancellation)	47
Committed Funding (actual + forecasted)	ZAR 290 million
Actual Disbursements	ZAR 166 million
Write offs	13%
Impairments	36%
Actual and Forecasted Reflows	ZAR 748 million
Actual and Forecasted Leakages	ZAR 273 million
Nominal Cash Flow	ZAR 185 million
Nominal IRR	7.5%

Source: IDC (2011).

Ultimately, the lowest level of investee impairments, unsurprisingly, was Business Partners with the ratio of impairments as a percentage of the portfolio standing at 6.8%. This divergence can be explained by two factors. First, it is a direct product of the kind of investments that the respective funds facilitate. The RCF and SEFA predominantly focus on funding early stage HDP projects and start-up operations. And second, many SMEs were challenged by difficult market conditions following the financial crisis.¹⁰¹

¹⁰⁰As a percentage of the overall portfolio at the end of March 2012 (IDC 2012).

¹⁰¹In light of this, investees believe that the RCF should be more perceptive to their development needs. Indeed, interviews suggested that they believe that in times of trouble, they are treated just as any other commercial investee. Interview conducted via phone with Joseph Ngoasheng, Managing Director of a Cement

While the figures above suggest that the portfolio investees are performing relatively well, the evaluation identified a concern relating to the financial sustainability of the RCF. Indeed, the financial sustainability of this innovative facility depends both on the ability to price its financial instruments accordingly, as well as the sustainability of the invested SMEs. Based on the interviews conducted, it became apparent that there was a problem concerning the loan duration of the financing instruments used by the RCF and its effect on the SME's financed. The RCF predominantly used unsecured subordinate loans (these make up 85% of the number of investments). It was noted that most RCF subordinate loans have the same terms (i.e. duration, grace period, repayment schedule) as general, non-development oriented IDC loans. However, with an average duration of 5 years, RCF subordinate loans do not provide the long-term support that many of these investments require. The implication is that the short loan duration drains the cash flow of the recipient company at a time when the growth of its activities requires increased working capital and possibly new investments. Ultimately this will affect the sustainability of the SME's financed and thus the RCF's future receivables.¹⁰²

While ultimately the RCF should still reach its targeted financial sustainability, these findings suggest that it needs to improve its results in a number of ways. According to the investment guidelines of the EIB-IDC Memorandum of Agreement, the loan duration for RCF loans should be around 8-12 years. Hence, in keeping with the Memorandum of Agreement, the RCF should implement these guidelines to allow for loan repayments to start significantly after typical IDC loans repayments. This longer grace period should not aggravate the risk in a substantial way, since most write offs usually occur within the first five years. When pressed on this issue, however, RCF staff noted that the reasons for not using more equity finance with longer grace periods is threefold. First, they expressed the difficulty to recoup administrative expenses on small transactions. Second, they suggested that increasing the use of real equity financing would substantially increase the administrative burden. And third, they mentioned a lack of manpower at the RCF staff level to provide board level management support to all investee's.¹⁰³

manufacturing SME financed by the RCF (February, 2012). For further detail see case study examples at the end of Evaluation Question 3.

¹⁰²Another factor determining the sustainability of the projects financed is the use of business support services, as will be discussed later.

¹⁰³Interview conducted with Meryl Mamathuba of the IDC (Pretoria, May 2011.)

With a view to evaluating the ultimate beneficiaries of the RCF, this evaluation question also aimed to provide selected case study examples of SMEs supported by RCF funds. These two examples will provide a brief analysis of the background of the SME's, an overview of their loan performance and development results, challenges faced, as well as the role of the RCF support with regard to the SME's growth potential.¹⁰⁴

First, "Blueberry Farm X" is a start up operation which launched in 2008. It consists of a 253 hectare blueberry farm located in South Africa's poorest region, the Eastern Cape. The business plan foresees the company to eventually grow blueberries on 230 hectares under weather protecting nets.

Table 5.6: Blueberry Farm RCF Loan Deal Summary

Type of Funding	RCF Amount (ZAR)	RCF Business Support	IDC co-investment (ZAR)	Other Investors (ZAR)	Investment instrument	Expected Return	Commitment date (legal agreement)
Start up capital	18,308,000	--	18,308,000	9,154,000	Preference shares	IRR 8%	12/06/2007

Source: IDC (2011a).

While the farm has sufficient water supply, it is currently running one year behind its business schedule due to unforeseen problems. So far, 32 hectares have been planted, with another 18 hectares currently under preparation. According to their Director, "The berries harvested have been of good quality, being successfully sold to local retailers such as Pick and Pay and Spar."¹⁰⁵ However, he also noted that the planted area has yielded limited produce so far, given harvests tend to take place in the second and third year of operations.

According to the RCF staff and the Investee's Director, the use of preference shares to support the company was the appropriate instrument as it increases the borrowing capacity of the SME. While the return to the RCF will be delayed due to the one-year project implementation lag, the IDC anticipates its forecasted return to be met. That being said, it was pointed out that for the IDC, the projected return of ZAR 1.1 million on an investment

¹⁰⁴Due to a non-disclosure agreement with the IDC, this thesis is unable to publish the real names of the investees.

¹⁰⁵Interview conducted with Philip Howes via phone in February 2012.

of ZAR 18.3 million was relatively low compared to other agricultural investees (see Table 5.6). Here the IDC may need to amend its returns.

Table 5.7 Blueberry Farm Performance Targets Overview

Assessment area	RCF Target	Forecasted	Achievement
SME Size	Any two of: <ul style="list-style-type: none"> • Less than 200 employees • Annual turnover of less than R51 million • Total assets of less than R55 million 	100% achievement	100% achievement
Job Creation	--	500	218
Cost per Job	ZAR 60,000	ZAR 47,000	ZAR 84,000
Geographic Location	65 % outside Gauteng Province and the Western Cape	--	Eastern Cape
HIV Aids Policy	Policy in place	Yes	Yes
Environmental Certification	RSA Certification	n/a	n/a
HDP and Women Empowerment			
HDP Managers	30%	2	16
BEE ownership	At least 25% + 1	100%	100%
Women ownership	30%	30%	n/a
Women jobs	30%	0%	65%
Women management	30%	1	4

Source: Source (IDC 2011b).

Despite the implementation lag, this RCF investee has been quite successful with regard to job creation and development targets. Thus far, Blueberry Farm X has created 218 new jobs, the majority of which are part-time (see Table 5.7).¹⁰⁶ With another 200 hectares remaining to be planted and harvested, it is therefore still possible that at the end of the loan term the company will have significantly empowered people from very poor backgrounds by

¹⁰⁶An important caveat here is that given the nature of the industry (berry farming), the majority of the jobs created were part-time rather than full-time jobs.

providing up to 500 jobs. What is more, the investee has implemented a HIV/AIDS policy which includes voluntary testing of staff members.

Concerning HDP and women empowerment, the project has achieved its HDP shareholding percentage, being above the 25%+1 agreement target. Yet the number of HDP shareholders is still lagging behind due to the fact that the farm has not reached its full capacity. Nonetheless, the project is exceeding both the general HDP managers target as well as the female HDP managers target (16 and 4 respectively.) While the figures for female shareholding were not available, the project has created 142 female jobs. This number represents 65% of jobs created, meaning that the 30% female shareholding target has also been met. Finally, while the assessed cost per job of ZAR 84,000 is higher than the forecast of ZAR 47,000, IDC staff interviewed indicated that given the remaining capacity of the blueberry farm, it is very likely that with project maturity this target will also be met.

Ultimately it seems that apart from the one-year implementation delay, this investee is performing well and is expected to achieve its overall performance targets. According to the managing director, the RCF funds have allowed the SME to become a profitable business, demonstrating clear growth potential. Prior to the support, the venture had been unable to take off due to the high costs of taking out a loan from private lending institutions. Consequently access to funds provided by the RCF allowed the company to take out additional loans and reduce its capital and interest repayments considerably. What is more, access to Business Support Services has enabled the SME to rework its repayment capability as well as optimizing plant preparation and disease management via professional consultation. According to the interviewee, the anticipated effect here would be the empowering of the workers at a quicker pace.¹⁰⁷

The second SME case study, “Cement Company Y”, was located in a township in the South Africa’s Northern Province and is a cement mixing production company. Following a two-year implementation delay due to technical problems with the installation of the plant, the company has been operational since 2009. Despite effective business operations and obtaining a South African Bureau of Standards (SABS) certificate for their product, this SME has been facing difficulties with RCF repayments, primarily due to a downturn in the construction industry. Furthermore, given the low barriers to entry in this market, the SME

¹⁰⁷Interview conducted with Philip Howes via telephone (February 2012).

faces numerous competitors.¹⁰⁸ As a result, the company had to approach the South African Department of Trade and Industry for additional grant financing of ZAR 1.6 million. This amount was granted, and a portion of it has been used to pay RCF arrears, with the rest of the grant being used for additional start up costs (in this case the purchase of a delivery van).

Table 5.8: Cement Company RCF Loan Deal Summary

Type of Funding	RCF Amount (ZAR)	RCF Business Support	IDC co-investment (ZAR)	Other Investors (ZAR)	Investment instrument	Expected Return	Commitment date (legal agreement)
Working capital	1,700,000	--	1,700,000	1,000,000	Subordinate Loan	IRR 6%	08/06/2007

Source: Source IDC (2011).

In terms of financial performance the company has not been very successful. The tough economic circumstances have contributed to lower than expected returns (see Table 5.8). The average revenues for this investee are currently estimated at ZAR 400,000 per month (ZAR 4.8 million for 2011). Yet this figure is far less than the ZAR 21 million it had forecasted by the year 2010 (even after taking into account the project delays). Despite capturing the additional government loan to pay IDC arrears, the fact that net profit margins remain low per bag of cement means that it would be difficult for the SME to improve its financial situation. While the use of a subordinate loan to finance this investee was seen as appropriate by the RCF, the use of equity with subsequent management support could have been more effective.¹⁰⁹

Unless this SME manages to implement a significant shift in its selling strategy, increase its profitability per cement bag, and captures a larger segment of the market, it is unlikely for the situation to improve anytime soon. Were it not for the grant from the DTI, this investee would battle to afford its current repayments. It is therefore anticipated that the RCF will not achieve its forecasted return for Cement Y.

¹⁰⁸High competition has translated into falling prices, implying a loss of profitability. In such cases, profitability can only be increased by streamlining the value chain, i.e. transportation of input materials and delivery transportation. Indeed, interviews revealed that the more successful cement manufacturers have streamlined their operations as they own the input and output transport logistics (interview conducted with Joseph Ngoasheng via phone in February 2012).

¹⁰⁹As confirmed by Francois Xavier Parant (EIB), interviewed in Cape Town (April 2011.)

Table 5.9: Cement Company Performance Targets

Assessment area	RCF Target	Forecasted	Achievement
SME Size	Any two of: <ul style="list-style-type: none"> • Less than 200 employees • Annual turnover of less than R51 million • Total assets of less than R55 million 	100% achievement	100% achievement
Job Creation	--	50	20
Cost per Job	ZAR 60,000	ZAR 34,000	ZAR 113,000
Geographic Location	65 % outside Gauteng Province and the Western Cape	--	Northern Province
HIV Aids Policy	Policy in place	Yes	No
Environmental Certification	RSA Certification	n/a	n/a
HDP and Women Empowerment			
BEE ownership	At least 25% + 1	100%	100%
HDP Managers (Male and Female)	30%	4	5
Women ownership	30%	30%	50%
Women jobs	30%	30%	5%
Women management	30%	30%	0%

Source: Source IDC (2011b).

With regard to job creation, the two-year delay and poor financial performance mean that the company has thus far only been able to hire 20 people, while the forecasted figure was a total of 50 jobs (see Table 5.9).

Given the low profitability and job creation of Cement Y at the time of evaluation, the analysis of the development performance indicators was a mixed bag. While this investee does not have an HIV/ AIDS policy, the project has achieved its HDP shareholding percentage (100%). It is also above the 25%+1 agreement target. Furthermore, the HDP manager target as well as female shareholding has been achieved (50%). Yet the project has no female managers, nor has it met the forecast HDP female jobs (1 assessed and 24

forecast). Lastly, the cost per job of ZAR 113,000 is significantly higher than the forecast of ZAR 34,000. Only if operations increase and financial performance improves will this target be met.

Ultimately, although this SME is not engaged in a complex business, the low sales and profitability of the industry are a major impediment. While the SME was able to commence operations with the RCF loan, the company faces considerable input and output logistics costs. However, by not supporting the investees as a minority shareholder, the RCF does not provide support to the SME management, neither at the board level, nor at the executive management level. This “lender” approach and the non-compulsory nature of this support provides no incentive to support the investees with Business Support Services. This view was confirmed during an interview with Nazeem Martin (Director of Business Partners), who argued: “Our ability to behave like an equity investor rather than a lender means that our client partners have a funder that will stand by them when times are tough.”¹¹⁰

While there is little that can be done about the market conditions, Cement Y has the ability to increase profitability (and consequently the donor’s development targets) by optimizing their supply chain. For instance, it could reduce its costs by bringing some of its cost components in-house, thereby improving the profitability. Here the RCF could considerably improve the SME’s situation by providing Business Support assistance in the areas of cost management, process streamlining, value chain streamlining, as well as coaching and mentoring. Consequently the RCF could and should play a more proactive role by providing real equity investment and subsequent technical assistance via its BSS grants.¹¹¹

Ultimately the evaluation found that the RCF generally achieved its own financing targets. When compared to wider SME support in South Africa it becomes clear that the results achieved were proportionate to the high risk investments which it targets; investments which would not receive financing by commercial financiers. The RCF represents the first comprehensive effort to support previously unbankable SMEs via risk capital financing in South Africa. In fact, a South African Venture Capitalist Fund manager

¹¹⁰Interview conducted with Nazeem Martin (Johannesburg, October 2011).

¹¹¹However given the use of subordinated loans will likely continue, it is vital that the grace period of the RCF loan be extended so as to cover, if possible, the accompanying senior loan repayment period of the DTI.

interviewed praised the very nature of this financing, stating that it represents a true added value in South Africa.¹¹²

This also seems to hold true when comparing the RCF financing results to the EU's global PSD financing results. The evaluation found that for the EU's global PSD interventions the linkages between EU support, SME financing and job creation remained distant at best. Nonetheless, whether blending can become a substitute for traditional grant based PSD support remains contentious.

5.24 Expertise and Flexibility

Evaluation Question 4: To what extent did engaging in Risk Capital Financing expand the EC's development assistance expertise compared to the traditional LED KZN?

This question aims to answer to what extent the donor was able to gain access to instruments and know-how with a view to improving the expertise of its development assistance. In terms of the reconstructed program theory, the question relates to the outputs level, addressing the issue of *relevance* (responding better to beneficiaries' needs) and *added value*, both for the donor (as it is expected to widen the range of what it can offer) and for the beneficiaries (as the intervention should allow a better response to their needs).

With a view to answering this question, the evaluation first sought to determine whether the traditional aid intervention and the innovative blending facility allowed the EC to offer leading expertise and experience to the beneficiaries? Regarding the traditional LED KZN, the aid programme was structured in a way that the recipients of the grant funding were responsible for securing their own expertise to implement their specific programmes. In the case of the implementing institution, the South African Department of Economic Development and Tourism, the donor programme manager highlighted a severe and continuing shortage of professional expertise. Symptoms of this malaise became evident during the lifespan of the support programme, notably when the managers of the implementing institution appointed to liaise with recipients found themselves becoming

¹¹²Interview conducted with J.P. Fourie (Johannesburg, May 2011).

frontline administrators.¹¹³ Instead of pursuing their intended responsibilities, they often had to help to prepare municipalities' submissions to the programme. Consequently the organisational structure of the LED KZN did not provide access to expertise which the EC would not have had available in house. Rather, an absence in a more fundamental professional competency in thinking about local economic development was exposed at the implementing level.

Concerning the RCF, partnering up with the European Investment Bank and a local Development Finance Institution was necessary for the donor given the EC cannot directly engage in private sector lending. The reason for this is that the EC cannot generate reflows when channelling grant finance. Consequently the EC also had no in house expertise for instruments such as risk capital operations.

In the case of the RCF, a local DFI was chosen as the implementing institution due to its ability to extend the necessary expertise and know how that the European Commission simply did not possess. The IDC's solid track record was particularly important to the donor. Interviews revealed that the IDC was chosen as the implementing DFI for a number of reasons.¹¹⁴ First, it was deemed as appropriate for absorbing the donor's grant financing. According to the EC's project manager, the relative size and experience of the IDC in the South African context would allow for the swift disbursement of Commission grant finance. Second, the IDC is an organ of the South African state, being part of the implementation of the government's economic and developmental policies, to which the EC has also aligned itself. Consequently channelling via the IDC facilitated alignment with government policy. Third, the thematic and national expertise of the IDC was important. The IDC's capability and experience as a lending institution in South Africa has given it technical expertise in various sectors. Despite the IDC's limited prior experience in small firm development, it had already embarked on providing risk capital funds in more established sectors and had a proven track record of being involved with private equity/venture capital. As a result it had created the necessary infrastructure to handle such an operation. What is more, directing funds via the IDC provided significant access to experience and country presence, where the EC is both not experienced enough and simply has too few human resources. Finally, the IDC's compliance with international standards was important too. The IDC works in

¹¹³Interview conducted in Pretoria (May 2011).

¹¹⁴Interview conducted with Milly Chesire (Pretoria, May 2011).

accordance with International Financial Reporting Standards and in the manner required by the Public Finance Management Act and the Companies Act of South Africa. This was backed up by a review by Independent Auditors in 2009, which found that the IDC's financial statements compiled were in line with the relevant provisions of the Public Finance Management Act of 1999 and International Financial Reporting Standards, and that they presented fairly the results of the operation, cash flow and financial position of the corporation (Chikonas 2009).

While the IDC essentially became the 'trustee' of the EC, it is the EIB, acting as a quality control for the DTI and the EC, which has provided the donor with a certain level of 'fiduciary comfort'. Here the evaluation revealed that the rationale for involving the EIB rests on the following factors. First, the EIB provided the donor with financial counter-checking and discipline by tracking the financial outcomes of the facility. Indeed, interviews confirmed that the role of the EIB as a watchdog over the use of EC funds has an effect on the financial discipline of the IDC.¹¹⁵ This is reinforced by the fact that the IDC has no part in potential losses of the RCF, thus being subject to moral hazard.¹¹⁶

Second, the EIB has the potential to increase the project quality by bringing technical expertise as an investment bank. As such, the EIB was instrumental to ensuring project quality by a) evaluating, approving or rejecting the investment proposals made by the IDC; b) overseeing, reviewing and monitoring the management, implementation and performance of the facility, ensuring that IDC manages RCF as per best practice; c) monitoring the performance of RCF funds on a quarterly and annual basis; and d) delivering an independent account of the performance of this innovative facility to the EC.

Third, the EIB facilitated a knowledge transfer as its expertise lies particularly in the private and public sectors of "viable infrastructure", SMEs, and environment.¹¹⁷ Indeed, the EIBs presence has facilitated a transfer of its technical and economic know-how to the RCF managers, i.e. with regard to reviews of environmental studies and pricing. Finally, the EIB is

¹¹⁵According to Milly Chesire, without the EIBs oversight, the IDC would probably behave differently (interview conducted in Pretoria, May 2011).

¹¹⁶"Moral Hazard" means that the parties might take undue risks since they profit from successful deals while not sharing in the potential losses. The EIB is not subject to moral hazard since it is a EU institution and supports EU development priorities and policies.

¹¹⁷Additionally, the EIB already has a mandate of supporting infrastructure projects of public interest and the private sector in South Africa. As such the risk capital available under the RCF has to be as complementary to the EIB's other operations in the country.

a EU institution (owned by EU member states) and supports EU development priorities and policies. Furthermore, it was noted that the EIB and the Commission share a common approach with regard to EU donor visibility.¹¹⁸

Not only does the EIB contribute to the operational management by overseeing the RCF's practices, it also has contributed with its financial and sectoral expertise and experience, allowing the IDC to directly benefit. With a view to demonstrating this expertise, the EC task manager gave the following example.¹¹⁹ As the interviewee pointed out, there used to be an issue surrounding the pricing of RCF loans, which, however, with the help of the EIB has now been resolved. According to the pricing model laid out in the IDC-EIB Memorandum of Agreement (MOA), the effective interest rate of the borrower was split into a monthly interest rate and a sweetener; the latter being linked to the turnover over a number of years during the life of the loan. Yet the problem with this set up was that the sweetener should be linked to the cash flow/profit and/or the value of the SME rather than the turnover, so as to closer resemble a share investment dividend or valuation. Upon realizing that the existing pricing mechanism was too high (initially targeted at RAT IRR of 10%) to attract sufficient deals, the EIB developed a new model based on the actual discount of the estimated flows and of the principal repayments. This mechanism allowed for a more appropriate pricing, ultimately increasing the financial sustainability of the SMEs financed and the RCF itself.

The second issue that this evaluation question addressed was whether the LED KZN and the RCF allowed the donor and its partner institutions to provide more flexible financial instruments for aid delivery? During the inception phase of the LED KZN, the programme coordinating unit and the contracting authority recognised that it was important to ensure that the framework established permitted a degree of flexibility. However the programme structure and the financing instrument used faced challenges throughout. While the LED KZN was not inherently inflexible, one interviewee pointed out that the program mirrored the generally risk-averse aid culture.¹²⁰ As such it did not allow the donor to gain access to new financing avenues to support private sector development in the region.

¹¹⁸Based on interview conducted with Francois Xavier Parant (Cape Town, April 2011).

¹¹⁹Interview conducted with Milly Chesire (Pretoria, May 2011).

¹²⁰ Interview conducted with Milly Chesire (Pretoria, May 2011).

In the case of the RCF, EC sources pointed out that the feasibility study was crucial in tailoring the facility to the recipients' needs, as it served as the basis for providing an incentive structure to allow for financing to SMEs in South Africa. What is more, IDC sources confirmed the view that the donor grant money allowed the IDC to offer additional financing mechanisms, with more attractive conditions for recipients, as well as to finance operations too risky for traditional lenders.

From the donor perspective, the idea of this innovative facility was to reconcile social welfare support through grants and commercial sector support through this funding mechanism, without distorting the market and providing undue windfall profit to the beneficiaries. Based on the interviews undertaken throughout the evaluation, none of the private sector representatives or RCF stakeholders complained about market distortion by the facility. Indeed, many were quick to point out that the RCF represented a market correcting initiative.¹²¹ Furthermore, EC officials interviewed collectively confirmed that in comparison to traditional aid and loans, this set up allowed a far more comprehensive and flexible response to the needs of partner countries. Consequently evidence suggests that the RCF facilitated a broader range of instruments and know-how, increasing the expertise of donor support in the process.

Ultimately, based on the results presented above, the LED KZN did not provide access to expertise which the EC would not have had available in house, nor did it allow for flexible aid delivery, thus mirroring the generally risk-averse aid culture. This finding seems to be consistent with the EU's global PSD support, as a 2013 report indicates that "The EU did not fully exploit its potential in terms of expertise and experience for PSD, which were not commensurate to the financial weight of the EU's PSD support" (ADE 2013 p. 15). The report also notes that the Commission's traditional aid modalities "lacked flexibility and agility to adjust to private sector actors and dynamics" (ADE 2013 p. 16).

Conversely, evidence suggests that by combining expertise, fostering donor coordination and providing technical assistance, the RCF provided the donor with the know-how and experience that it could not have facilitated via its traditional aid modalities. Furthermore, the RCF allowed the Commission to offer a variety of instruments, thus increasing leverage and flexibility of its aid delivery.

¹²¹Interview conducted with J.P. Fourie (Johannesburg, May 2011).

5.25 Implementation Cost and Time

Evaluation Question 5: To what degree did the donor grant financing to the RCF contribute to lower transaction costs and a swifter implementation than the LED KZN?

The aim of this question is to verify how efficient the innovative aid modality of risk capital financing is compared to the Commission's traditional interventions with regard to implementation time and cost reduction. Consequently this question addresses the *effectiveness* and *efficiency* criteria at the results and outcomes level in our reconstructed program theory. With a view to comparing the RCF to the LED KZN, this evaluation question invokes both the delays in implementation as well as the transaction costs (management cost and time) incurred.

In terms of implementation time, while the RCF1 took 18.5 months from project identification to project implementation, the RCF2 took 13.6 months from the Commission decision to extend the programme to the signature of contract implementation between the EIB and the IDC. However, as will be discussed below, the actual implementation of the RCF2 was extended a further three years. In comparison, the LED KZN, which covered only one financing phase, required 21 months from project identification to project implementation (see Table 5.10).

Table 5.10: Delays in Implementation: RCF vs. LED KZN

Assessment Area	RCF	LED KZN
<i>Time needed between project identification and project implementation</i>	RCF1: 18.5 months RCF2: 13.6 months + Riders	21 months
How much time did it take from first identification study of the project to the proposal decision?	RCF1: 16 months RCF2: not applicable	12 months
How much time did it take from proposal decision to signature of Contribution Agreement?	RCF1: 2.5 months RCF2: 2.6 months	3 months

How much time did it take from signature of Contribution Agreement to signature of contract for implementation?	RCF1: 0 months RCF2: 11 months.	6 months
Were these delays in line with expectations?	Yes.	Yes.

Source: RCF Financing Agreements and Interviews (2011).

With regard to the LED KZN, the final evaluation report for the project concluded that delays and hold ups in the implementation process could be attributed to the low project management efficiency of the implementing institutions at the municipal level. The report further concludes that these hold ups had to be compensated for by the EC staff responsible for the project. However, the same report also noted that the LED KZN still managed to disburse approximately 80% of its budget, deeming the overall efficiency for a programme of this nature and scale to be good.

Concerning the RCF, EC staff interviewed¹²² also suggested that the time between project identification and the funding agreement was more or less within the standard timeframe of Commission decisions, with minor hold ups related to the signature of the Financing Agreement (signed between the EC and the DTI), the EC-EIB Memorandum of Understanding (MOU) regarding technical assistance for the Programme, as well as another Memorandum of Agreement between the EIB and IDC regarding the management of the Programme (which is also the contract for implementation). In the case of RCF2, the Commission decision to enter a second phase of funding for the RCF was taken in December 2005 while the EC-DTI agreement was signed by the DTI in February 2006. With regard to the EC-EIB MOU and the EIB-IDC MOA, these two agreements took about 11 months to be signed after the signing of the EC decision in December 2005. According to the EC staff, this minor delay in the implementation of the RCF2 was a result of a number of factors. First, the design of the RCF2 was different from and more comprehensive than the RCF1's. Here lessons learnt from RCF1 had to be incorporated in RCF2. Second, the RCF team had to develop a new pricing policy. And third, the increased

¹²²Interview conducted with Richard Young (Johannesburg, May 2011).

monitoring and evaluation responsibilities bestowed on the EIB required more detailed contractual agreements between the implementing institutions (the IDC and EIB).

For the RCF2, donor support was made available in three tranches. The original agreement foresaw the EUR 50 million grant being released over a period of three consecutive years. This, however, did not occur and the agreement has been revised twice through two different riders extending the project implementation period by three years.¹²³ Furthermore, the RCF2 experienced a further delay for the release of its third tranche due to the depreciation of the South African Rand against the Euro. Due to the depreciation, more funds were available in local currency than originally envisaged, making it difficult for the IDC to fulfill a special condition for the release of the third tranche, namely that 80% of the funds transferred in the first and second tranches were committed.

The evaluation also found that there were minor delays in the implementation of the RCF2 due to the stringent development conditionalities imposed by the financing agreement. Nonetheless, according to the RCF staff interviewed, despite the conditionalities, the donor avoided further hold ups by approving a number of riders to the financing agreement allowing for the release of all three financing tranches.

Finally, despite the respective delays for the RCF and the LED KZN, EC staff pointed out that both these delays were in line with expectations and mirrored past experiences with EC funded programmes. Furthermore, given both aid modalities followed the formal EU implementation guidelines, the evaluation demonstrated that with the exception of some overly stringent donor conditionalities for the RCF, the reasons for the respective delays were largely based on hold-up problems in contractual agreements with the local implementing institutions, as well as issues with their implementation capacities. While interviews with EC staff suggest that the implementation of the RCF could have probably been expedited by the provision of a formal guidance document to assist EC task managers with decision making when channelling to facilities such as the RCF, it would be wrong to conclude that one modality has demonstrated greater efficiency in terms of implementation time.¹²⁴

¹²³Due to the depreciation, more funds were available in local currency than originally envisaged, making it difficult for the IDC to fulfill a special condition for the release of the third tranche, namely that 80% of the funds transferred in the first and second tranches were committed.

¹²⁴Interview conducted with Milly Chesire (Pretoria, May 2011).

In addition to the implementation time, this evaluation question also compared the management cost for the innovative RCF and the traditional LED KZN respectively. Here evidence suggests that the RCF has significantly reduced the transaction costs of aid delivery for the European Commission (see Table 5.11).

With regard to the traditional project aid modality, given the timeframe and scale of the programme, a relatively large number of EU staff were necessary for the implementation of the LED KZN. While the number of staff members varied during the lifetime of the programme, at the busiest time a total number of 26 full time experts were employed as part of the EU's Project Coordinating Unit.¹²⁵ Furthermore, EC documents indicated that the total implementation cost over the six-year span of the LED KZN amounted to EUR 9.2 million, or 24% of the total project value. In comparison, the RCF required only one full time EC employee in the day-to-day management of the programme, and implementation costs amounted to EUR 5.2 million. This represented around 5% of the project value; a fraction of the cost incurred by traditional projects such as the LED KZN.¹²⁶

Table 5.11: Transaction Costs: RCF vs. LED KZN

Assessment Area	RCF	LED KZN
<i>Transaction costs of project</i>		
How many EC staff were involved in the day-to-day management?	1	26 ¹²⁷
Implementation (including management) and follow up cost?	EUR 430 thousand per year ¹²⁸ EUR 8,200 per week	EUR 1.5 million per year ¹²⁹ EUR 28,800 per week
Hours per week that management staff spends on respective programmes (per person).	5 hours per week.	40 hours per week.

¹²⁵The Project Coordinating Unit staff was responsible for overseeing the implementation of the programme.

¹²⁶Since the EC uses standard follow up and evaluation procedures, the costs incurred for the two respective Programmes were more or less the same.

¹²⁷At full capacity (varied over course of project).

¹²⁸Total cost divided by duration of Programme: RCF1: EUR 1.5 million; RCF2: EUR 3.7 million; Total: EUR 5.2 million; Duration 12 years. Cost includes management fees of EIB and IDC.

¹²⁹EUR 9.2 million total; Duration 6 years.

Implementation cost as a proportion of project value (%) ¹³⁰	5%	24%
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Source: European Commission (2005, 2006) and Survey Questionnaire (2011).

According to the evaluation reports and EC staff interviewed, the reasons the RCF's cost efficiency were three-fold. First, given that only one full time employee was responsible for the blending facility at the donor level, this aid modality lowered the management time significantly for the EC. Second, the management fees of the implementing institutions (EIB and the IDC) were low when compared to the donors in house management fees.¹³¹ Finally, the cost reduction was also credited to the expertise of the implementing institutions in the field of SME financing.¹³²

The evaluation did, however, reveal two concerns regarding the IDC and EIB management fees. First, with regard to the IDC, the management fees are computed on real yearly expenses and shall not exceed 10% of yearly re-flows. Hence yearly expenses can only be covered by yearly reflows. However, due to the time lag between investments and re-flows (investments and expenses usually take place up-front, while reflows can take time to materialize), the effectiveness of this scheme has to be questioned. While RCF staff claimed that this is projected to change once the pushed back internal rate of return comes into the picture, at the time of the evaluation the yearly average amount of expenses incurred were much higher than the receipts. According to the EU delegations head of development cooperation in South Africa, this set up provides an incentive for RCF staff to maximise re-flows, i.e. to select the least risky investments.¹³³ Not only could this come at the cost of projects that need RCF financing the most, but it also represents a negative incentive in the way the RCF operates. Additionally, in several interviews it was pointed out that RCF investments provide a significant support to the IDC's own commercial lending. The aim of the RCF was to push the IDC to lend to more risky investees, thus promoting development objectives shared by the donor. Consequently RCF funding should not be used for IDC

¹³⁰Implementation cost taken as a proportion of normalized cost for project duration (i.e. RCF yearly cost of project EUR 108 million over 12 years.)

¹³¹The management fees of the EIB were paid by the donor, while the management fees of the IDC were paid by yearly reflows of the RCF.

¹³²Interview with Milly Chesire (Pretoria, May 2011).

¹³³Interview conducted with Richard Young (Johannesburg, May 2011).

mainstream commercial lending. While IDC and EC staff acknowledged that this was going on, it was pointed out that this is the exception rather than the norm.

Second, there is currently no incentive built into the EIB management fees to facilitate the completion of the project. As it stands, the EIB receives a fixed monthly management fee of EUR 42,000 (with a maximum of EUR 2,5 million per financing cycle). Ideally, however, with a view to incentivizing the EIB management fees, the EIB should be charged a percentage equivalent to the write offs of RCF1 and RCF2 in excess of the targeted 30%. Furthermore, the fact that the EIB contract was delivered outside the usual competitive procedure, the EIB being a sister institution of the EC, does not facilitate assessing the market value of the EC – EIB agreement.

Ultimately, while the results above demonstrate some delays in the implementation of the RCF and the LED KZN, these were generally line with the donors' expectations. One interviewee pointed out that "whereas the multi-stakeholder nature of the RCF initially led to implementation delays and additional start up costs, these costs were ultimately augmented by low management costs and previous costs of non-cooperation."¹³⁴ Indeed, while the management fees in this blending arrangement could have been incentivised better, the administrative costs were considered very low by the EC staff interviewed. As a result all stakeholders interviewed agreed that on the whole, the RCF reduced the transaction costs of aid delivery for the donor in comparison to its traditional interventions, demonstrating considerable value for money of this innovative approach.

¹³⁴Interview with Milly Chesire (Pretoria, May 2011).

6 Overall Case Study Evaluation Findings

Donor agencies and governments, tax payers, partner country governments and citizens all want aid to work as well as it can. Aid budgets are limited and therefore need to be well targeted and managed. Having outlined some of the aid modalities in the constantly evolving field of development aid earlier in this thesis, the aim of this chapter is to provide overall findings and key lessons learnt with regard to the value for money of the RCF compared to its counterfactuals. While VfM cannot be the only factor in the decision to pursue one form of aid delivery over the other, and while the study results are by no means representative of all blending facilities, this methodological approach has been invaluable with a view to gaining an in-depth understanding of blending mechanisms. What is more VfM frameworks enable agencies to put forward a powerful narrative of the real impact and value of their work. Consequently, prior to engaging the wider political economy considerations surrounding development financing, this chapter will tackle the question of whether this innovative aid modality provided more value for money than its traditional counterfactuals, and if so where.

The ability to provide VfM is presented in the four groupings outlined in the reconstructed program theory, notably: inputs, outputs, results and outcomes. This addresses both the question concerning what was achieved that would not have been achieved otherwise and what the potential risks of this new aid modality are. Ultimately the chapter provides a summary of the overall VfM exerted.

6.1 Value at the Input Level

At the input level of the reconstructed program theory, the evaluation demonstrated that even though the RCF was not based on a specific EC strategy document, grant financing for the RCF took place in the context of growing support for blending and was done in compliance with the formal guidance criteria for the financing modality used. While some of the RCF's conditionalities proved overly rigid this was a result of the innovative nature of

the risk capital financing and the inherent lack of documented guidelines available for decision makers.

The decision to fund the RCF was taken at EC headquarters in conjunction with the EC Delegation and is a direct product of the donors Private Sector Development Strategy as defined in South Africa's Country Strategy Paper. Hence RCF1 and RCF2 can to an extent be explained by the regional cooperation agreements. A more nuanced understanding, however, would argue that RCF funding has to be seen in the context of a more general trend: notably a growing demand for blending and multilateralism with implicit incentives.

As was discussed earlier in this thesis, the resurgence of catalytic aid is driven by the fiscal pressures in donor countries and the desire to increasingly work with the private sector. Consequently the ability of blending to use more targeted solutions for working with the private sector and to use grant resources as effectively as possible by leveraging additional development funds has translated into heightened support for non-traditional aid modalities such as the RCF.

With regard to the organizational structure at the input level, the RCF was structured in a logical and coherent manner and seems very relevant in the South African context. The three distribution channels facilitated the leverage of EU funds with the IDC and third party funds. What is more, the introduction of business support was an important contribution to the lending culture of the IDC as a whole. Given the EC could not directly intervene in the local SME market via traditional aid modalities, the channelling of grant financing via the IDC was the most appropriate way to facilitate the RCF. Furthermore, by involving the EIB in this set up, the EC was able to provide the necessary counter checking power to circumvent the potential for moral hazard given the IDC is not subject to potential losses.

Finally, while the EC Delegation generally provided the Commission headquarters with credible and readily available information on its aid delivery through the RCF, what is still needed is effective interaction and data sharing within the Commission and other organisations involved. Evidence suggests that this was equally problematic for the donor's traditional aid interventions. At the task manager level, the lack of strategic guidance from headquarters meant that most decisions at the intervention's conception stage had to be taken on an ad-hoc basis. That being said, the RCF has in many ways the ability to serve as an example to future blending practices by the EC, not only because of its success in terms of financing results, but in terms of implementation and expertise. Indeed, the evaluation

hinted at the fact that blending mechanisms such as the RCF will play an increasingly important role in different fields of action including, *inter alia*, energy, environment, transport, climate change and private sector cooperation, and contribute to achieving the MDGs and supporting important political initiatives.¹³⁵

6.2 Value at the Output Level

In terms of value at the output level, this section looks at operational lessons on the effectiveness of aid delivery through the RCF, notably on the attainment of results and the promotion of EU policies. This includes the question of what benefits and risks were observed compared to the implementation and follow up of the LED KZN and the EU's global PSD support between 2004 and 2010.

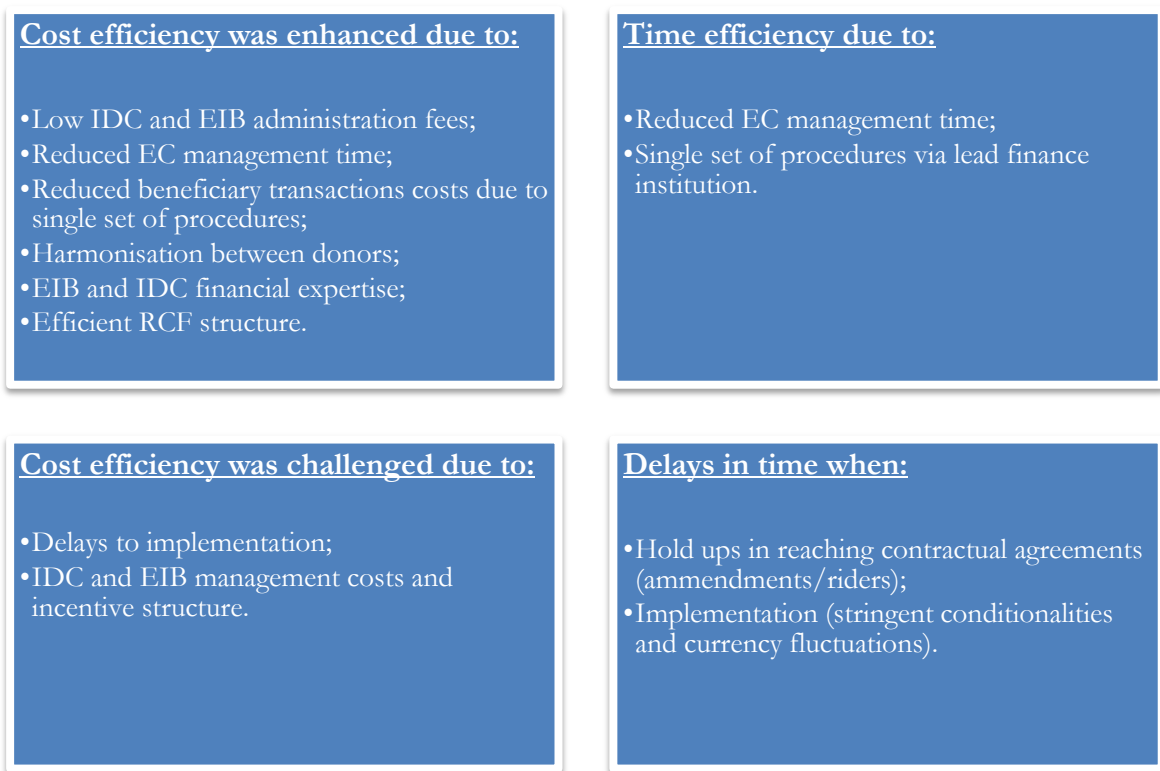
The operational benefits highlighted by the evaluation are as follows. First, innovative blending provides considerable value in terms of supporting private sector development in partner countries at the micro level. Despite some lag in implementation and the failure of the Third Party Channel, overall, the evaluation suggests that the RCF provided a particular added value in terms of financial leverage, SME financing and job creation compared to EU's global PSD activities. While there were caveats regarding the kind of jobs created, and how job distribution was divided amongst the SME's financed, this was still a success when compared to the donor's global PSD support. Indeed, interviews at the donor headquarters suggested that the EU's PSD support lacked a systematic approach to integrating job creation as a key objective in aid modalities. Concerning SME financing, the donor's global PSD support demonstrated little evidence of improved access to finance for SMEs between 2004 and 2010.

Second, by involving the EIB in this set up, the EC was able to provide the necessary counter checking power to circumvent the potential for moral hazard. Consequently, the combination of donor support with finance from financial institutions has the potential to enhance financial discipline of a project during the various stages of preparation, implementation and management (i.e. via risk sharing, notably making the partner institution contribute its own funds).

¹³⁵As consistently reflected in interviews with policymakers throughout the evaluation.

Third, blending facilities reduce the administrative costs of channelling aid and allow the donor to take advantage of the loan provider's project management expertise. Here the assessment of the RCF's overall aid delivery costs against the traditional LED KZN aid modality demonstrated the extent to which innovative blending may promote efficiency, both for the Commission and the other stakeholders involved. This is also true for the EIB, demonstrating efficacy with regard to management time and transaction costs during the whole financing cycle (see Figure 6.1). Furthermore, traditional aid did not provide access to expertise which the EC would not have had available in house, nor did it allow for flexible aid delivery, thus mirroring the generally risk-averse aid culture.

Figure 6.1: Efficiency of RCF Aid Delivery



Fourth, blending can reduce the management time of aid interventions by using public grant finance and the market expertise of partner DFIs. While there were minor delays due

to adjustments to the terms and conditions of the Financing Agreement¹³⁶ as well as unresolved issues regarding the incentive structures of IDC and EIB management costs, on the whole the RCF reduced EC management time compared to its traditional interventions and allowed for a swift and cost-effective implementation of its PSD Strategy in South Africa. By streamlining the RCF lending activities via a lead finance institution, all the stakeholders involved ultimately benefitted from common set of rules and procedures. Moreover, many DFIs lack the resources to provide fully-fledged technical assistance with every project. By providing subsidies for additional technical assistance, capacity building and project preparation will further enhance project acceleration.

Finally, the multi-stakeholder approach of blending mechanisms has the ability to “pool” activities that would otherwise be pursued by donors or DFIs individually. Indeed, interaction with the EIB allowed for the advancement of common EU development policy and provided the necessary counterchecking expertise and fiduciary confidence that the EC could not achieve with its traditional aid modalities due to its lack of lending expertise. As a result, blending mechanisms address the principles laid out in the Paris Declaration on Aid Effectiveness. Indeed, coordination among bilateral (and multilateral) donors and finance institutions avoids the duplication of efforts and has the ability to take advantage of the individual strengths of the financing partners, thereby increasing the efficiency of channelling aid (as well as increasing the financing volume and spreading operational risks). Moreover, improved donor coordination via blending mechanisms also has the ability to increase efficiency at the beneficiary level, given it reduces the contact points and administrative hurdles.

While the operational benefits of blending mechanisms for donors are substantial, the evaluation results of the previous chapter also highlighted a number of operational risks. The first concern surrounds the realization that the success of blending mechanisms does not only rely on donor support and coordination. It is also subject to the will and quality of management at the beneficiary level. While the organizational structure was a success on the whole, the evaluation highlighted a number of concerns, notably: a) failure of the Third Party Channel; b) lack of real equity financing to SMEs; c) limited use of Business Support Services; and d) moral hazard. On the basis of the results presented in the previous chapter,

¹³⁶It is understood that some adjustments to the terms and conditions of the Financing Agreement could have been modified more rapidly, and that issues with implementation led to further delays.

the underlying reasons for these concerns are twofold. First, the weak empowerment of the RCF account officers needs to be highlighted. The RCF Unit lacked the capacity and manpower to create a workable implementation model for the Third Party Channel. Furthermore, its over reliance on other IDC units and limited staff constrain the RCF's ability to offer more equity financing with subsequent management support.

Second, apart from capacity constraints, beneficiary institutions should also have been committed to ensuring transparent and effective implementation on their part. Here the RCF experience demonstrated that constraints may derive from the, sometimes, perverse incentives via management costs to support projects in the field of global public goods. IDC management fees are set up in a way that prompts RCF task managers to maximize re-flows i.e. select good risks. Not only could this come at the cost of projects that need RCF financing the most, but it also represents a negative incentive in the way the RCF operates, i.e. RCF staff will continue to select good risks and use financial instruments and loan terms that maximize reflows, rather than focus on development objectives. Furthermore, in several interviews it was pointed out that RCF investments provide support to the IDC's own commercial lending, pushing IDC to promote more risky operations than would be warranted if the IDC did not benefit from increased loan operations. Considering that the IDC does not share in RCF potential losses, this behaviour represents another form of moral hazard.

Ultimately, the main lesson in this respect is the importance and complexity of providing the right incentive structure via management fees and identifying the proper financial instrument to be used in the support of the financial needs of SMEs. While the decision making for the RCF was generally sound, lessons learnt ought to be made available in the form of a formal guidance document easily accessible to others. This was pointed out by the EC project officer for the RCF, who noted that while it was necessary to leave sufficient room for flexibility in decision-making, additional guidance documents concerning blending instruments would be helpful. Such a document should refer to the results of previous blending facilities, current good practices, as well as an over-arching strategy document. For instance, the RCF evaluation points to the importance of supporting RCF investees from a real shareholders' perspective, which implies taking a strong management position through an empowered RCF unit. Ultimately sharing these experiences should serve as a basis for

providing EC project officers with a manual of instructions on how to manage blending facilities in the context of the project management cycle.

The second concern relates to the possibility that donors may risk losing control and visibility of their support. By setting up joint financing structures there is a possibility that single donors may lose some visibility and control. For instance, EU blending mechanisms, although financed by member states, are to a large extent EU instruments. Decisions are largely made at the European level and such coordination enhances the visibility of the EU, not of its individual donors. While this is not a major risk, it may act as a disincentive for blending to be pursued more proactively at a multilateral level.

Finally, although this was not the case for the RCF, another potential operational weakness of blending mechanisms comes with the complexity of coordinating multiple stakeholders. Here pooling of resources could lead to a slowdown in decision-making as coordination may be hampered by varying internal procedures and rules. Additionally, the form of development conditionality may also be a source of disagreement. That being said, while initial disagreement may lead to an increase in transaction costs in the short term, the experiences with the RCF demonstrated that the costs are ultimately augmented by previous costs of non-cooperation as well as subsequent economies of scale.

6.3 Value at the Results Level

At the results level of the reconstructed program theory, the evaluation highlighted a number of economic benefits and risks for the various stakeholders in terms of addressing market failures and project financing uptake. Additionally this section will discuss the financial benefits and risks at the results level, invoking the role of financial leverage effect and the ability of increasingly involving the private sector as a credible partner in development.

As demonstrated in the results of the previous chapter, the economic benefits of blending can address issues surrounding market failures. Blending loans and grants has the ability to change the overall cost-benefit balance of development projects, thereby correcting possible market failures. More specifically, the provision of blended finance allowed projects to take off which would not have been able to without the delivery of this innovative support. This may include providing finance to projects that would not have received

finance otherwise due to the risk perception: i.e. costly or high-risk projects such as previously unbankable SMEs or municipal infrastructure projects. In the case of the RCF, innovative blending provided considerable value in terms of facilitating an adapted aid framework that provides incentives both for local financial institutions and the private sector, thus supporting private sector development in partner countries at the micro level.¹³⁷

Apart from project uptake, the RCF experience demonstrated that blending mechanisms also allow financing for projects with higher social than financial returns, i.e. where positive externalities (environmental and/or social benefits) outweigh the financial rate of return. As was outlined earlier in the thesis, this has become one of the key priorities of policymakers following the 2008 financial crisis. In this case the grant may be structured so as to “buy” the public good which is “produced” by the project, as well as compensating any extra expenses that are involved. Blending could therefore also be an important tool allowing projects to start up that do not raise user-charge revenue. This is particularly relevant for social projects that due to their financial viability are not attractive for private financial institutions. Alternatively, a grant element may also be used to internalize possible negative externalities associated with projects. For instance, the extra cost associated with redesigning a fuel power plant to a wind farm may be covered by the blending element.¹³⁸ Hence blending has the ability to act as a corrective measure in case of market failure and the provision of public goods.

While from an economic rationale the experiences with the RCF were overwhelmingly positive, there remain risks of blending mechanisms which should be pointed out. First, when deciding whether to provide blended finance, the possibility of crowding out other financing sources needs to be considered. For instance, in cases where sufficient financial resources are already available and the given project is bankable, providing concessional finance via blending should be avoided. This is all the more relevant in medium income countries with well-developed financial markets.

Second, blending can lead to market distortions if certain projects or financial intermediaries benefit from an unfair advantage as a result of the donor support. While this was not the case for the RCF, donors have to make sure that they are provided with

¹³⁷Here RCF grant elements also demonstrated the ability to reduce the overall cost and risk of SMEs financed, as well as reduce the interest repayments for the recipients of loans

¹³⁸However the provision of aid to private companies to mitigate their negative environmental costs has to be vigorously evaluated in line with the polluter-pays-principle.

sufficient information to assure that their support does not lead to any form of market distortion. This is true both at the micro and macro level. Indeed, Bulow and Rogoff (2005) and Klein and Harford (2005) argue that by disproportionately increasing the number and size of development loans there is a real risk of creating a development bias towards middle income countries, given that low income countries have a lesser capacity to service loans.

While this is certainly also related to the increased availability of private investment in middle income countries, a report by the ECDPM (2011) argues that the risk of creating a development bias is limited for blending mechanisms given that measures could be put in place to control for such biases (i.e. at the strategic and operational level). This is supported by the fact that the share of EU funding currently channelled through these facilities is still modest. Furthermore, the report argues that blending mechanisms can offer a solution to this problem rather than exacerbating it. Indeed, if well managed, increased blending allows for a better division of projects into those that can only be financed exclusively by grants and those that are bankable.

The RCF evaluation also confirmed considerable financial added value of blending compared to traditional aid. First, blending has the ability to combine limited donor grant money with loans, leveraging additional resources from partner institutions. Here blending has the ability to crowd in private investment by covering certain risks to make projects bankable. As outlined above, the financial contributions channelled to the RCF led to donor funds being leveraged by 529% compared to 28% by the LED KZN. A large portion of this finance came from the private sector via the Niche Fund Channel. Furthermore, the RCF facilitated a crowding in effect for SME financing within the IDC (ZAR 1.4 billion).¹³⁹ As a result blending mechanisms allowed more projects to be financed than by pure grants alone.

Second, as discussed above, blending has the ability to increase the uptake and lower the borrowing costs for SMEs that face high borrowing constraints. By providing the IDC with EC grant finance, the RCF was devised in a way to enable the use of a wide range of risky financial instruments which allowed for sizeable investments in a previously neglected sector (mostly via subordinate unsecured loans). This would not have been possible via traditional

¹³⁹ While there is very little evidence to suggest that channelling through the IDC has increased EC ODA in the country, there is a general consensus that the ECs RCF channelling has led to a crowding in of development finance in various forms.

aid modalities such as the LED KZN. Additionally, blending facilities could make use of equity risk sharing in the form of guarantees, which can have positive impact on the credit quality of a project. To give an example, the 'Europe 2020 Bond Initiative' aims to structure their project financing so as to absorb the lack of cash being available to service the senior debt of a development project (due to risk perception), thereby raising its credit quality.

Third, the RCF demonstrated its ability to offer tailor made solutions to the recipients' needs, increasing the flexibility of development finance, and providing better incentive structures compared to its counterfactuals. Indeed, stand alone grants in the form of traditional ODA and loans may at times prove rigid and ill-suited to the local development needs. For example, one of the risks of excessive grant financing is its ability to distort market signals, thus undermining the effectiveness of project selection, as well as impeding the development of the private sector. In this context the RCF demonstrated the ability of this innovative aid modality to conform to the needs and demands of the recipient.

According to the blending literature and the experiences with the case study, donors also need to consider a number of financial risks associated with blending, the first of which is relates to the possibility of moral hazard (Ferrer and Behrens 2011). As explained earlier, moral hazard describes a situation where someone who is shielded from risk behaves differently than he would if he was fully exposed to the risk. With regard to blending, the provision of donor grant financing could act as an incentive for a lender to go beyond the economically sensible and prudent limits of indebtedness. In the case study it was pointed out that in several cases RCF investments provided significant support to the IDC's own commercial lending, pushing IDC to promote more risky operations than would be warranted if IDC did not benefit from increased loan operations. This behaviour represents a form of moral hazard.

Additionally an ECDPM (2011) report notes that moral hazard is also likely when development projects are of strategic importance to individual donors or are being pushed by powerful domestic stakeholders in the beneficiary country. Such a situation could also lead to excessive concessionality when providing blended finance. Recognising their beneficial standing, beneficiaries may try and maximise donor support by playing off the different donors. It is therefore imperative that as in the case of the RCF, donor support is provided transparently, with the emphasis on the efficiency of project design in question.

Second, donors need to consider the possibility of insufficient risk provision. When blending involves covering risks that the private sector was unwilling or unable to take up, it is crucial that the risk profile is clearly defined and accounted for in the budgetary position to avoid unforeseen additional costs. Nonetheless, lending partners generally have to incur some risk when lending in developing countries. What is more, in the case of the RCF, the evaluation demonstrated the ability of blending mechanisms to reduce this risk to an acceptable level.

Third, while the financial leverage effect is a critical donor objective, the measurement of financial leverage remains a contentious topic, with varying approaches among and within donor institutions. While the European Commission has recently implemented several blending instruments via its regional Investment Facilities, there is no uniformity on the measurement of financial leverage. For example, the EC's Neighbourhood Investment Facility (NIF) calculates its leverage effect as the level of financing that grant elements have attracted for any kind of grants, technical assistance included. Using this definition the overall leverage effect of the NIF is 25 times the original investment (Ferrer et al 2011). Yet another investment facility run by the European Commission, the EU Africa Infrastructure Trust Fund (ITF), uses a more conservative approach and excludes technical assistance when calculating financial leverage. For the ITF, the total financial leverage is estimated at 13.5 times the grant share. The problem is that depending on the facility in question, the way in which financial leverage is calculated can be misleading, i.e. when the grant element is mainly comprised by technical assistance. Hence there is a necessity to harmonise the calculation of 'financial leverage' across the facilities.

Fourth, there exists an on-going dispute regarding the interface between blending and ODA. This thesis previously defined ODA as grants or loans to developing countries which are: (a) undertaken by the official sector; (b) with promotion of economic development and welfare as the main objective; and (c) at concessional financial terms of 25% or more compared to a 10% reference interest rate (35% for tied aid) (OECD 2014a). Yet loans from donor agencies must also fulfil the concessionality requirement set at below the competitive market rate. Given that interest rates have fallen since the 1970's, blended finance with a grant element of 5% often meet the 25% concessionality criteria (ECDPM, 2011). Hence when blending loans and grants, the loan value of the particular project could be counted as

ODA (for qualifying funds), allowing donors to move towards their ODA targets by counting loan funds that were previously not recorded as ODA.

According to the OECD, this could have the effect of lowering ambitions in terms of donor grant levels. As a result the OECD has a long-standing practice of putting an additional interest rate subsidy (IRS) on top of the concessionality requirements for accounting financial packages as ODA. Yet the EC is challenging this (ECFIN 2009). It argues that in practice, many non-IRS operations do not channel the full grant amount to the financial intermediaries, but rather separately to the beneficiaries. In these cases it is difficult to count the assistance, and the financiers loan may fail the concessionality criteria for ODA accounting. In addition, the implicit grants of member states embedded into the loans of the financiers are not well accounted for, again underestimating the total level of concessionality in a project.

Finally, another contentious issue surrounding blending and ODA is whether funds provided by third parties to form parts of a blending package should be recorded as ODA. In the case of the RCF, the majority of the finance made available for SMEs ultimately came from the IDC and private investors. While single concessional loan funds can be recorded as ODA, they cannot when those funds are provided to a third party (i.e. European Investment Bank) and then re-combined in the blending package. Given the importance donors put on scaling up ODA efforts, this may act as a disincentive for future blending practices.¹⁴⁰ Furthermore, the inclusion of capital reimbursements as negative ODA in the yearly statistics by OECD represents a substantive challenge and political limitation to the interest of blended loans in the context of ODA calculations. Hence the question whether blending mechanisms can contribute to an increase of the ODA depends on the on-going discussions with and within the OECD.

¹⁴⁰This is assuming that donors are still aiming at maximizing ODA budgets to achieve the target of 0.7% of GDP. However given the trend is quickly changing towards Value for Money, this may no longer be the case, rendering the question whether third party funds via blending mechanisms can be recorded as ODA as less pertinent.

6.4 Value at the Outcomes Level

At the outcomes level, the evaluation highlighted a number of strategic and policy benefits of blending mechanisms. As will be discussed below, these primarily address the benefits of targeting resources in a manner that is not possible via traditional aid delivery mechanisms.

With regard to the strategic and policy dimension of donor support, the evaluation confirmed benefits with regard to policy leverage. Indeed, financial leverage was not the only and maybe not the most important impact of the RCF. On the basis of multiple interviews and the survey, the evaluation revealed that EC channelling led to policy leverage with regard to sector specific policies and projects. This means that blending mechanisms enable focusing donor resources on sectors and projects that are regarded as the most needy/important, consequently making important projects with large development impacts possible which may not have taken place otherwise.

In the case of the RCF, EC funding itself facilitated the critical mass necessary for the SME support to take place in the first place. Using blending as a tool to leverage dialogue on policy and associated measures enables donors to influence the recipient's policy in areas with priority, such as SME support, capacity training or the environment. In the case of the RCF, apart from the initial project uptake, the donor was able to facilitate policy leverage in a number of areas. First, it increased awareness and set a precedent for this kind of funding leading to a crowding in effect of similar kind of funds targeted at SMEs within the IDC (worth ZAR 1.4 billion).¹⁴¹ Since the creation of the RCF, the IDC now houses a few similar facilities. Like the RCF, these funds also target risky enterprises with a development impact. As such it has contributed to the evolution of the IDC towards SME financing, which was initially not part of its mandate. Not only has this demonstrated the IDC's ease with working with such entities alongside its traditional target sectors, but it has also paved the way for the continuation of support for this marginalised sector in the future.¹⁴²

Second, the donor funded RCF has brought about the mainstreaming of business support, now catering to all lending activities in the IDC. While the business support uptake is still low, the fact that it is now available is likely going to lead to a much more hands on

¹⁴¹See Evaluation Question 1 for overview of SME funds set up within the IDC.

¹⁴²While the LED KZN findings suggest some policy leverage too, these were empirically less compelling.

lending approach within the IDC, ultimately increasing the effectiveness of IDC loans as a whole.

Third, while the RCF did not facilitate cooperation within the donor institution, one of the strategic impacts of this project has been the improved cooperation between the various development institutions involved, fostered by the multi-stakeholder approach. To use a specific example, due to the RCF, the IDC and the EIB have improved cooperation in other areas of financial support granted by the EIB to South Africa through the IDC. What is more, the RCF has also fostered cooperation within the IDC itself and among other private and government supported SME institutions in South Africa (i.e. Business Partners and Khula).¹⁴³

Finally, by providing donor grant money via the IDC, the donor has been able to push its objective of furthering the capacities of a local financial intermediary. Indeed, housing the RCF has further developed the IDC as an institution and enhanced its capacities. With the RCF becoming a fully-fledged Strategic Business Unit, it has influenced the institution as whole. There are several examples that support this conclusion. First, the RCF facilitated the setting up of the Post Monitoring Business Unit, which also caters to other IDC activities. Second, the RCF was instrumental in the creation of the Business Support Programme, which is now applied to all of the IDC's operations. Moreover, in addition to adopting actual departments initiated by this facility, the EIB's presence has facilitated a knowledge transfer of its technical and economic know-how to the RCF managers, notably with regard to reviews of environmental studies and pricing. Not only did this enhance the capacity building of the RCF team, but it also provided opportunities for a closer cooperation between these two large development finance institutions. Lastly, the evaluation indicated that the implementing institution has shown a real commitment to the delivery of the best results, proof of the strong appropriation and ownership impact that the EC pursues via its aid modalities.¹⁴⁴

¹⁴³With regard to the in house cooperation, the IDC's decision to regroup the various funds supporting SMEs under the RCF SBU umbrella increased coherence as well as the professionalism of the IDC account officers. Regarding other SME institutions in South Africa, increased cooperation can be exemplified by the appointment of a former senior staff member of the RCF as the managing director of Khula, a parastatal lending institution in South Africa.

¹⁴⁴ It should also be mentioned that the RCF was implemented at a time when few Venture Capital companies were professionally organized, which allowed for an appropriation of the Programme by the IDC.

6.5 Overall Value for Money

In the 1990s catalytic aid was very much on the defensive, being replaced by broader efforts at financial sector reform. Today aid modalities such as the RCF provide evidence that a new form of financial intermediary aid is making a comeback. Indeed, the findings above suggest that innovative blending mechanism provided considerable VfM at various levels of aid delivery compared to the traditional aid delivery mechanisms.

At the input level, the RCF demonstrated value in terms of its coherent and logical organizational structure and the ability of the EC delegation to monitor its aid delivery. While data sharing at the headquarters level was problematic, this was not specific to blending as it proved to be an overall shortcoming of the EUs aid delivery.

At the output level, the evaluation highlighted several operational benefits of blending over traditional aid. Here the RCF reduced the transaction costs of aid delivery due to diminished management time and fees, and promoted synergies between public and private sector interventions, including finance. Moreover, the multi stakeholder financing structure fostered coherence and coordination, allowing for a pooling of activities that would otherwise be pursued individually or not at all.

At the results level, the evaluation demonstrated a number of economic and financial benefits of blending over traditional aid delivery. Most notably, blending addressed an underlying market failure in the recipient country by providing an ‘exogenous incentive’ in the form of EC grant, pushing the IDC to engage in lending to a previously unbankable/disenfranchised sector and thereby enabling project uptake of projects with higher social than financial returns. Consequently the RCF is providing an important added value in terms of SME financing compared to EU's global PSD activities.

Concerning the financial value of blending, the evaluation suggested that these are threefold compared to traditional aid. First, blending has the ability to combine limited donor grant money with loans, leveraging additional resources from partner institutions. Second, blending has the ability to increase the uptake and lower the borrowing costs for SMEs that face high borrowing constraints. And third, the RCF demonstrated its ability to offer tailor made solutions to the recipients’ needs, increasing the flexibility of development finance, and providing better incentive structures than traditional aid in terms of involving the private sector in development.

At the outcomes level, evidence suggests that blending has strategic and policy benefits over traditional aid. The evaluation showed that blending has the ability to lead to policy leverage with regard to sector specific policies and projects. By providing the critical mass of financing necessary for the SME support to take place in the first place, blending contributed to the evolution of the IDC towards SME financing, which was initially not part of its mandate. This included crowding in additional finance within the IDC as well as private investment.

These findings suggest that blending has the ability to bring about transformative change. Indeed, as highlighted in the literature review at the outset of the thesis, donors are constantly in search of transmission mechanisms which deliver or support transformative change from the outside. And while conditionality has largely been discredited to provide that credible link between aid, growth and sustainable institutional change, the innovative blending mechanisms may provide an opportunity in terms of helping developing countries increasingly pursue change by themselves. Indeed, as our evaluation highlighted, while the role of the implementing institution, the IDC, was key in the success of the RCF, the organisational set up of the RCF also facilitated a knowledge transfer in expertise and experience to the IDC, one of the leading South African DFI's. In a country where aid from abroad plays a relatively minor role, one EC interviewee argued: "The real value provided by aid (in South Africa) is not the finance itself but what comes with it: best practice, innovation, risk-taking, pilot programmes, systems development, capacity building, and above all skills and knowledge."¹⁴⁵

While traditional donor institutions such as the EU will continue to 'learn by doing', and innovative financing is certainly not a substitute for all traditional grant based assistance, the results of the RCF ultimately indicate that innovative finance mechanisms have the ability to enhance the value for money of development assistance at various points, from initial mobilization to actual absorption. With a view to pursuing greater development effectiveness and ensuring that donor promises are kept, traditional donors should therefore make greater use of innovative modalities such as the Risk Capital Facility.

¹⁴⁵Interview conducted with Richard Young (Pretoria, May 2011).

7 Conclusions: Value for Money and Collective Action Problems

The aim of this chapter is to draw on the empirical findings to offer some conclusions regarding the ability of innovative finance to help overcome collective action problems and thus improve the effectiveness of development aid. The following conclusions surround the potential of new aid delivery mechanisms to provide not only more aid, but also better coordinated, more legitimate, predictable, and flexible aid. While the evaluation results indicate that innovative aid modalities have the ability to translate into higher equilibrium allocations for the donor in terms of aid delivery, this thesis could not empirically verify whether the provision of innovative finance mechanisms led to a reduction in welfare losses brought about by the collective action problems of aid.¹⁴⁶

7.1 Financial Commitments: Ability to Provide More Assistance

For reasons of turf fighting and vested interests in donor countries, it would be reasonable to assume that little can be expected from traditional ODA channels to make extraordinary efforts to meet the 0.7% targets by 2015. This is all the more the case since the financial crisis and ensuing economic crisis will make it increasingly difficult to justify scaling up ODA budgets in the short term (with donor countries facing harsh budget constraints).

It is within this context that innovative aid modalities such as the RCF may play a countervailing role. As demonstrated in the previous chapter, the RCF incentivised a direct financial leverage effect as well as a crowding in effect of similar forms of development lending within the implementing institution itself. Here the potential of facilities such as the RCF to engage new partners and generate additional development funds is a clear point of departure in the context of the political economy discussion surrounding innovative

¹⁴⁶This was not possible due to a lack of data on the impact of innovative mechanisms. In the future a noteworthy point of departure for further research in this regard would be the work of Steinwand (2012) who employed a model to explore if selective incentives related to trade, good governance, and diplomatic goals could help alleviate the negative welfare effects of free-riding losses.

development assistance and ODA commitments. The findings presented in the previous chapter suggest two conclusions regarding the ability of innovative blending to scale up development assistance.

First, innovative financing for development has the ability to leverage additional development resources from new sources allowing traditional donors to spend their aid strategically to maximise the resources currently at their disposal. Here the RCF demonstrated that donors may aim to strategically allocate existing ODA resources aligned with their objectives while taking advantage of the considerable leverage effect of this innovative aid modality. In addition to the experiences of our case study, a whole host of innovative mechanisms exist which have already leveraged additional and untapped sources of development finance. According to estimates by the World Bank (2009 p. 14), innovative fund-raising already accounted for around US\$ 57.1 billion in official flows, or an estimated 4.5% of total gross bond proceeds and official aid by International Finance Institutions between 2000 and 2008. Over the same period, financial flows supporting innovative financial solutions accounted for at least US\$ 52.7 billion in official flows or 5.7% of total ODA to recipient countries (World Bank 2009 p. 9). On average these innovations grew 10% annually in volume terms over the same period.

The potential for innovative blending may be even greater. As the case study suggested, innovative blending mechanisms have the ability to raise additional and untapped resources which could make a crucial difference in ensuring that the development finance gap is closed. The rise of new financing modalities should prompt aid agencies to rethink the role of public-private partnerships in development cooperation and to increasingly consider the potential of catalytic mechanisms. The figures speak volumes: net private flows to the developing world increased from US\$ 193.4 billion in 1998 to US\$ 646.8 billion in 2006. While the figures dropped off substantially following the financial crisis in 2008, they were back at US\$ 775 billion in 2012 (CONCORD 2013). In comparison, global ODA provided by the 22 members of the DAC was US\$ 125.9 billion in 2012. Furthermore, the largest source of funds for development will eventually come from developing countries' domestic resources (Gates 2010).

In theory, the ability of innovative blending to tap into these funds allows donors to generate development finance which effectively bypasses strenuous and conflict-prone annual budgetary allocation decisions in national parliaments, subsequently overcoming the

implications of turf fighting in national budget allocations.¹⁴⁷ This is warranted by the fact that other contributors such as private financiers operate outside the fiscal competences of donor countries. In the context of the reduction in aid following the financial crisis, this could play a crucial role in complementing wavering ODA commitments and disbursements.

While in terms of sheer financing potential these forms of innovative ‘market based aid’ merit more attention, a possible caveat, however, is the ability to count these additional development sources as ODA. For instance, while the experiences with the RCF have demonstrated the potential to significantly scale up development resources for a particular development objective, these cannot be counted as ODA. What is more, leveraging additional development resources has no explicit impact on the vested interests and institutional turf fights constraining donors from scaling up ODA commitments. Yet while there may not be an explicit impact, implicitly the VfM that these new aid modalities offer could play a crucial role in allowing donor institutions to push for ODA commitments to be met. This brings us to the second conclusion, notably that the ability to scale up, or at the minimum maintain, ODA budgets in national parliaments can be indirectly induced by innovative mechanisms raising the benefits of cooperative solutions or the costs of defection for donor agencies.

Given the overall political logic of aid provision and the institutional arrangements that govern it, chapter one discussed why aid is consistently undersupplied and thus considered a scarce resource. Until now, official donor aid allocations depend on constant negotiations between national ministries, whose budgets are generally decided on an annual basis, and whose strategies change according to policy objectives and priorities. This arbitrage is contingent on incentives originating from the scarcity of domestic resources available and the vested interests, turf fighting and bureaucratic inertia which govern the annual budgeting process (Vaubel 1986; Steinwand 2012). Furthermore the poor track record of aid mobilisation is also dependent on changeable political circumstances, such as electoral promises, and lobbying power of non-state actors.

With fiscal consolidation in donor countries putting downward pressure on aid budgets, donor governments are increasingly starting to care about the costs of aid provision too. It is

¹⁴⁷With the exception of mechanisms that would involve a re-channelling of ODA, and would thus need to be approved in donor countries parliamentary budget decisions. However, as will below, here the leverage capacity of innovative forms of ‘market based aid’ may directly offset this shortcoming.

within this context that innovative blending mechanisms may play a role in overcoming the above mentioned collective action problems. As was demonstrated in the evaluation, innovative blending can expose both the costs of non-cooperation between donors, as well as the high costs of traditional aid delivery. Indeed, if development aid is perceived to be effective and in the interest of the donor country, development agencies may forge alliances to win consensus in parliamentary budgeting procedures. An excellent example of this at the EU level was the initiation of the debate surrounding the implementation of a Financial Transaction Tax by France's Nicolas Sarkozy and Germany's Angela Merkel at the European Council meeting of June 17th 2010. Here, collective action problems were overcome by reducing the effective number of veto players to a few important figures who are able to shape the views of all other actors (Pollack 1997).

Consequently, by demonstrating the VfM of innovative mechanisms, development ministries could ultimately influence policy too. In building on the work of Scharpf (2006) and Steinwand (2013), the findings of the case study suggest that innovative financing would allow donor agencies currently constrained by more powerful domestic actors to make a compelling case for more aid in national parliaments. By highlighting the potential that these mechanisms have in complementing traditional ODA disbursements as well as appeasing national constituencies such as investor lobbies, development actors could increasingly rally support around the issue. This would allow those actors who want to scale up ODA in national parliaments to make a compelling case for doing so, thereby reducing the effective number of veto players by rallying a general dynamic of support around aid in general, and blending in particular. In theory, this could forge a consensus in terms of increasing financial contributions towards blending, thus avoiding the implications of collective action problems for proposals to scale up ODA, or, at minima, avoid other actors from claiming their turf, i.e. by pushing for budget allocations to be diverted towards rival agencies and actors higher up in government.¹⁴⁸

¹⁴⁸Unfortunately the evaluation was unable to provide evidence of whether this is already happening in the EU. However, as was mentioned earlier, this could be an interesting area for further research.

7.2 Ability to Provide Better Assistance

Apart from overcoming collective action problems to allow for more development financing, innovative financing modalities may induce better coordinated, more legitimate, more predictable, and more flexible assistance as well. In the context of the political economy discussion this allows for the formulation of a number of conclusions.

First, innovative finance mechanisms can increase the coherence between donor approaches, avoiding non-coordination and duplication of efforts via their multi-stakeholder financing structures. As was discussed by Balogen (2005) as well as Frot et al (2010), the concept of coherence is an integral part in the debate surrounding how to increase aid effectiveness. Here innovative aid modalities may substantially improve donor coherence if pursued more proactively. Indeed, one of the direct impacts of the RCF has been the improved cooperation between the various development institutions involved, fostering a multi-stakeholder approach. By “pooling” activities that would otherwise be pursued by donors or DFIs individually, blending mechanisms subsequently tackle the principles laid out in the Paris Declaration on Aid Effectiveness on harmonization and coordination of procedures. This addresses the desired effects of increased aid coordination, donor alignment with country strategies, and cutting the ‘compliance burden’ on aid recipients. Furthermore, although not a direct effect, implicitly the increased focus on innovative mechanisms such as the RCF could induce enhanced networks within donor institutions which would share information, facilitate coordination, improve communications, and ultimately minimize unnecessary incoherence.

Second, by demonstrating the VfM in terms of aid delivery costs, innovative blending may expose the costs of non-coordination through bilateral aid channels and induce donor governments to channel more aid multilaterally. Barder et al (2010) emphasize that more money needs to be channelled through multilateral agencies. This, however, may only be possible if vested interests at the national donor level are overcome. Indeed, as Olson’s theory suggests, the rational donor has little or no interest in the absence of selective incentives in voluntarily contributing to a collective action that is to produce public or collective goods. While this implies a difficulty in terms of scaling up aid, it also explains why aid continues to be so uncoordinated. Indeed, here free-riding of donors leads to the continued bilateralisation of aid efforts in the pursuit of own economic and strategic

interests and thereby incurs high transaction costs.

Bigsten (2006) and Barder et al (2010) argue that national governments could in fact be induced to reduce their bilateral ODA share in exchange for more aid going to multilateral mechanisms if the costs of non-coordination and/or continuing bilateralisation were to be made transparent so that national decision makers can be held accountable by their taxpayers for the use of development funds. For innovative aid modalities this means that they need to be perceived as providing better value for money than traditional ODA. Hence similar to the potential ability to scale up ODA budgets by raising the benefits of cooperative solutions or the costs of defection for donor agencies, the selective incentives created by innovative blending mechanisms could play an important role here too.

With a view to addressing the bilateral *modus operandi* of donor ODA, policymakers need to demonstrate the VfM of innovative facilities such as the RCF, emphasizing the ability of multi-stakeholder structures such as the RCF to lower the cost of aid delivery, thus increasing the costs of non-cooperation. Here donor institutions such as the European Commission could make use of their agenda setting powers to create informal forums of discussion around blending mechanisms, exposing the costs of non-coordination and/or continuing bilateralisation of traditional aid vis a vis blending. For instance, policymakers could demonstrate that compared to direct interventions, EC management time was significantly reduced under the RCF. What is more, the coordination functions of multilateral blending structures have the ability to decrease transaction costs of aid delivery for the donor and the recipient.

Third, innovative blending ensures greater political legitimacy of development finance by mobilising a wide-ranging involvement and commitment of non-state actors in development cooperation, bolstering the input legitimacy of development finance. What is more, by focusing on results, the output legitimacy of development finance is strengthened. In applying the principle-agent framework to the aid architecture, chapter one shed some light on the sources of delegated authority and legitimacy of the aid system. Based on the work of Bardet et al (2010), OECD donor agencies invariably suffer from input and output legitimacy problems. Here the experiences with the RCF have reinforced the notion that innovative financing has the ability to increase the input and output legitimacy of development assistance. With regard to input legitimacy, the political economy discussion put forward the argument that since global challenges increasingly cut across donor, sector,

and national frontiers, an encompassing view needs to consider the legitimizing elements that non-traditional, innovative solutions bring to the table. Here the RCF demonstrated the ability of blending mechanisms to mobilise a wide-ranging involvement and commitment of non-state actors in development cooperation, bolstering the input legitimacy of development finance.

With regard to the output legitimacy of a system, this was defined as its capacity to achieve the goals defined in its mandate. Drawing on the findings of the case study, the RCF has shown significant value for money while simultaneously offering more targeted solutions for recipients and fulfilling the donor's development objectives. Indeed, by focusing on results, innovative financing has the ability to increase the output legitimacy of development finance.

Fourth, innovative blending allows for more consistent and predictable financial flows, subsequently strengthening efforts of partner country administrations to plan and execute budget appropriations more efficiently. Indeed, predictability must be recognized as a key condition for increasing the impact of ODA. Bourguignon et al (2007) demonstrated that efforts to spur human development and poverty alleviation are principally based on recurrent expenditures in social services. Thus unpredictable variations in the transfer of resources to developing countries has a negative incidence on the effectiveness of aid since recipient governments experience difficulties in meeting financial commitments over a medium term budgetary perspective, eventually leading to an erratic stop-and-go policy and budget implementation. As mentioned above, in several cases innovative finance may either have the ability to circumvent or abate such political short-termism or mobilise additional sources of private money.

While aid predictability is not a direct concern for MICs such as South Africa, the RCF has demonstrated how blending may induce sustainable support for public good initiatives by strengthening ownership and fostering sector policy leverage. Indeed, by encouraging ownership and accountability of donor funds via the involvement of partner DFIs, the RCF has crowded in additional domestic resources for the support of disenfranchised SMEs. Ultimately the transformative nature and the appropriation of this support by recipient institutions will guarantee predictable support beyond donor involvement and therefore has to be acknowledged as a crucial condition for maximizing the impact of ODA.

Finally, innovative financing allows the flow of development assistance in a targeted

manner, involving new partners in development and channelling the funds more efficiently to implementing entities such as DFIs, governments, civil society, or private actors. Traditional aid channels are constrained not only in terms of financing, but also in terms of their ability to engage new partners for development and to deal with increasingly diverse development problems (Rogerson 2011). As consistently reflected in interviews with development practitioners throughout the research phase of this thesis, the role of the private sector in development is now seen as integral element for donor agencies. This, however, is a relatively recent phenomenon. For many decades private sector involvement in development was limited for ideological reasons, which shaped aid modalities in a way that they were often unable to work with new development partners, including the private sector. For instance, traditional aid delivery mechanisms such as project aid allow for large-scale infrastructure projects in recipient countries to be financed, but are unable to directly on-lend to small businesses in these countries.

Over the last decade, developing countries have thus started to demand both more finance as well as more effective financial solutions for development (Ratha 2008). A major driving factor in this development was the rigidity of traditional aid modalities and the understanding that there was no silver bullet for the increasingly wide-ranging development challenges. This led to the realization that what was needed was a broader menu of financial instruments tailored to the particular needs in question. In this context, innovative financing modalities could play a promising role. In building on the work of Ratha (2008), the case study demonstrated that innovative aid modalities can offer tailor made solutions to the recipients' needs, increasing the flexibility of development finance, and provide better incentive structures. Here the RCF experience verified that donor agencies have the ability to harness the potential of the private sector in development, to optimize the timing of development assistance to better correspond actual development needs, to help actors address various types of risks, as well as to increase the concessionality of aid flows.

Ultimately, based on the foregoing discussion, the role of innovative financing for development can play both an explicit and implicit role in enhancing the effectiveness of development assistance. In the context of the political economy discussion, however, it is the ability to provide selective incentives whereby it may address collective action problems that constrain traditional aid, such as free riding, vested interests, and institutional turf fighting which enables the donor to reach higher equilibrium allocations of aid allocation.

Consequently these innovative aid modalities represent a new beginning in the context of the evolution of ODA, offering donor institutions an effective complementary approach to achieving their development objectives.

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Appendices

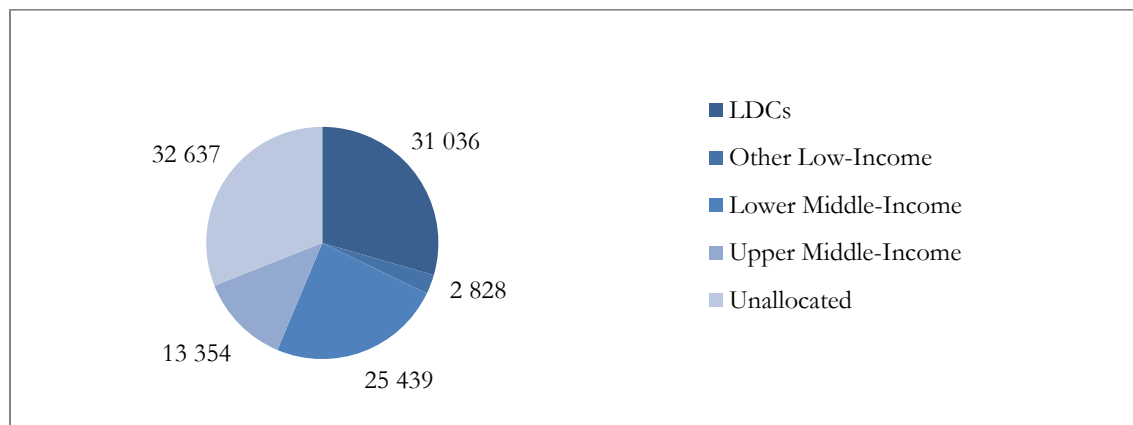
Appendix A: DAC Aid Performance

Figure A. 1: DAC Country Aid Contributions

	2012		2011		2012	2011-2012
	ODA US\$ million (current)	ODA/ GNI %	ODA US\$ million (current)	ODA/ GNI %	ODA US\$ million (2011 prices and exchange rates)	% change 2011 to 2012
DAC Countries						
Australia	5,440.0	0.36	4,983.0	0.34	5,436.0	9.1
Austria	1,112.0	0.28	1,111.0	0.27	1,180.0	6.1
Belgium	2,303.0	0.47	2,807.0	0.54	2,442.0	-13
Canada	5,678.0	0.32	5,459.0	0.32	5,682.0	4.1
Denmark	2,718.0	0.84	2,931.0	0.85	2,879.0	-1.8
Finland	1,320.0	0.53	1,406.0	0.53	1,400.0	-0.4
France	12,000.0	0.45	12,997.0	0.46	12,785.0	-1.6
Germany	13,108.0	0.38	14,093.0	0.39	13,991.0	-0.7
Greece	324.0	0.13	425.0	0.15	353.0	-17
Iceland	26.0	0.22	26.0	0.21	27.0	5.7
Ireland	809.0	0.48	914.0	0.51	860.0	-5.8
Italy	2,639.0	0.13	4,326.0	0.20	2,823.0	-34.7
Japan	10,494.0	0.17	10,831.0	0.18	10,601.0	-2.1
Korea	1,551.0	0.14	1,325.0	0.12	1,557.0	17.6
Luxembourg	432.0	1.00	409.0	0.97	449.0	9.8
Netherlands	5,524.0	0.71	6,344.0	0.75	5,928.0	-6.6
New Zealand	455.0	0.28	424.0	0.28	437.0	3
Norway	4,754.0	0.93	4,756.0	0.96	4,773.0	0.4
Portugal	567.0	0.27	708.0	0.31	615.0	-13.1
Spain	1,948.0	0.15	4,173.0	0.29	2,101.0	-49.7
Sweden	5,242.0	0.99	5,603.0	1.02	5,411.0	-3.4
Switzerland	3,022.0	0.45	3,051.0	0.45	3,188.0	4.5
United Kingdom	13,659.0	0.56	13,832.0	0.56	13,532.0	-2.2
United States	30,460.0	0.19	30,783.0	0.20	29,907.0	-2.8
TOTAL DAC	125,586.0	0.29	133,716.0	0.31	128,356.0	-4
Average Country Effort	10,046.8	0.43	10,697.3	0.47	10,268.5	-3.9

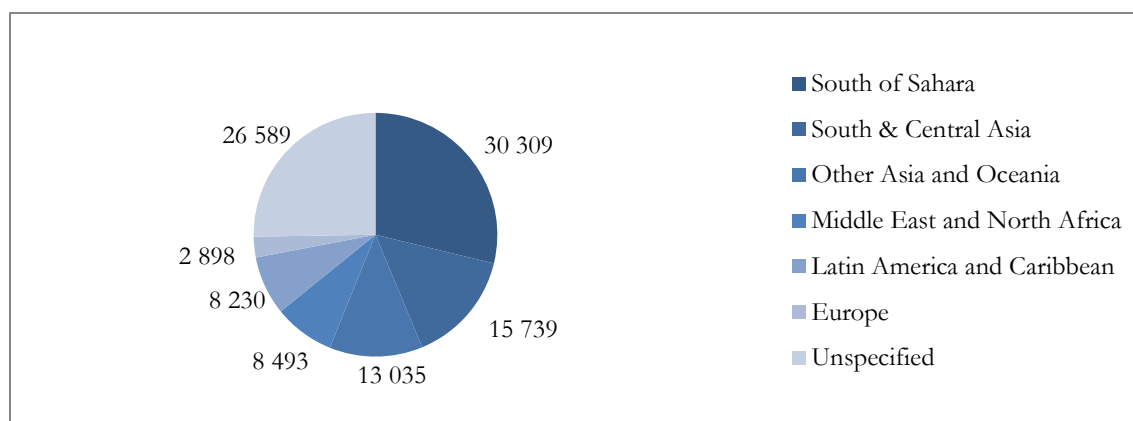
Source: OECD (2014).

Figure A. 2: DAC Gross Bilateral ODA, 2011-2012, by Income Group (US\$ million)



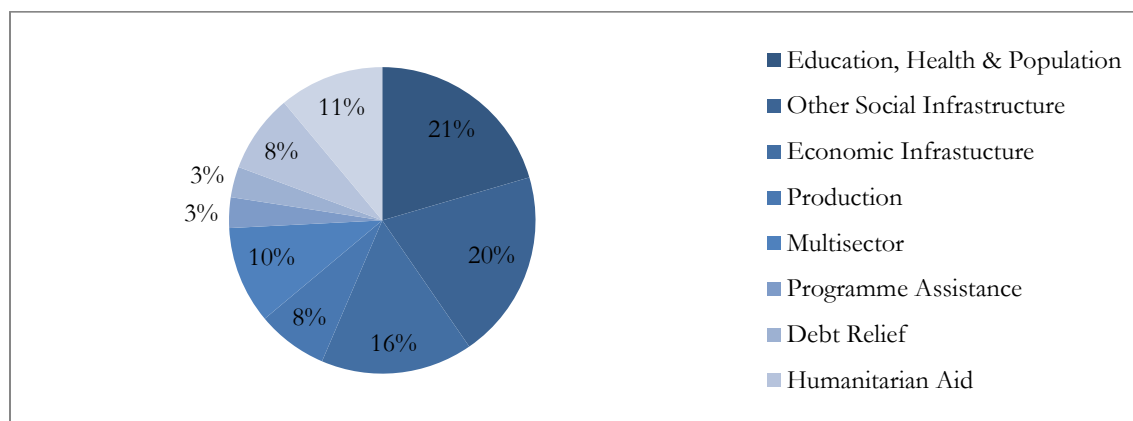
Source: OECD (2014).

Figure A. 3: DAC Gross Bilateral ODA, 2011-2012, by Region (US\$ million)



Source: OECD (2014).

Figure A. 4: DAC Gross Bilateral ODA, 2011-2012, % by Sector



Source: OECD (2014).

Appendix B: Overview of Innovative Finance Mechanisms

Figure A. 5: Overview of Innovative Finance Mechanisms

IFM	Development Purpose	Functioning and Scope	Revenues
PRIVATE MECHANISMS			
Voluntary Contributions	Private fundraising and pro bono activities.	Philanthropy, i.e. online microfinance platforms.	In the USA it represents more than 1.5% of national income.
SOLIDARITY MECHANISMS			
a. New sources of Solidarity			
Auctioning/ sale of emission permits (2009)¹⁴⁹	Funds for climate mitigation/adaptation.	Only existing scheme is EU Emission Trading Scheme (ETS). Here emission allowances are sold to emitters, raising revenue for donor governments.	So far only Germany's 2009 budget allocated EUR 225 million in ETS sales to development.
Currency Transaction Levy (Conceptual)	Governments impose micro tax (0.005%) on foreign exchange transactions.	0.005% tax on major currency transactions for implementing governments.	Could yield between US\$ 33-60 billion.
Airline Ticket Levy (2009)	Raising funds to improve access to treatments against HIV/AIDS, malaria and tuberculosis.	13 countries impose domestic tax on airline tickets. Funds are channelled to UNTAID platform.	US\$ 300 million a year.
Development Lottery (Conceptual)	Funds for development from national/pan national lottery intakes.	Using lotteries to raise funds for public sector projects.	Implementation of an EU wide charity lottery system could raise EUR 10 billion each year
Global Digital Solidarity Fund (2003)	Aims to foster an inclusive information society.	Public or private bodies voluntarily donate 1% of digital procurement contracts.	More than EUR 30 million allocated to 300 grantees since 2003.
b. Innovative Uses of Solidarity Funds			

¹⁴⁹The year indicates since when the instrument exists.

Adaptation Fund (2010)	Funding for environmental adaptation in developing countries.	Funds adaptation projects and programmes in developing country that are especially vulnerable to the adverse effects of climate change.	Funded by 2% share of Certified Emission Reductions (CERs) issued for most Clean Development Mechanism (CDM) projects. Value of CERs received to-date about US\$ 110 million.
IMF Special Drawing Rights Transfer (Conceptual)	Additional IMF SDRs for developing countries for either: 1) instant liquidity needs; 2) additional concessionality; 3) financing climate change adaptation.	Developed countries that do not need the additional liquidity could donate surplus SDRs to developing countries.	Funds could be substantial, i.e. US\$ 100 billion by 2020 for Green Fund.
Swap mechanisms (2006)	Swap mechanisms involve a form of debt forgiveness targeted at specific development efforts.	Developed country creditors agree to cancel a share of the non-performing debt owed to them in exchange for a promise by the debtor government to invest the cancelled amount in approved projects.	Less than US\$ 1 billion per year.
PUBLIC PRIVATE PARTNERSHIPS			
a. Innovative Fund-raising through Partnerships			
Frontloading: International Finance Facility for Immunization (2006)	Frontloads donor ODA commitments for immunisation and health systems campaigns.	Bonds are sold in the international capital markets against legally binding long-term ODA commitments from 9 donor countries. Funds are then directed to Global Alliance for Vaccine Immunization.	US\$ 2.4 billion raised by 2009. Aim is to raise a total of US\$ 4 billion over implementation period.
Global Climate Change Financing Mechanism (Conceptual)	Frontloads finance to climate related investments through the issuance of bonds on international financial markets.	Bonds are sold in the international capital markets against legally binding long-term ODA commitments.	n/a

Innovative Indexed Bonds (2008)	Targeted debt titles issued by the public sector to raise finance and or fund specific projects or policies and help debtors hedge against risks originating from fluctuations of the index.	Indexed bonds tie the performance (schedule or amount of payment of interest and/or of repayment of principal) to the performance of an index (i.e. currency, weather, GDP, etc).	World Bank 'Green Bond' issued in 2008 has raised US\$ 800 million.
Future Flow Securitization	Innovative approach to raising bond finance and improving developing countries' access to international capital markets.	Securitization of future flow receivables via the bond market. In such a transaction, the borrower pledges its future foreign-currency receivables (i.e., oil, remittances) as collateral to a special purpose vehicle.	Difficult to estimate. One example has been the case of El Salvador, where remittance-backed securities were rated investment grade, two to four notches above the sub-investment grade sovereign rating.
b. Innovative Partnership Solutions at the Country Level			
Global Emerging Markets Local Currency Bond Program (2007)	Addresses devaluation risk related to foreign-currency borrowing by generating local-currency denominated resources for governments in selected emerging market countries.	Invests funds in emerging bond markets. Launched by World Bank together with private partners.	US\$ 5 billion local currency bond for investment in up to 40 emerging bond markets.
CATALYTIC			
a. New Sources for Catalyzing PSD			
Climate Investment Funds consisting of a Clean Technology Fund and Strategic Climate Fund (2008)	Support low-carbon and climate-resilient development via scaled-up financing channelled through 5 multilateral development banks.	Both funds have are comprised of a Trust Fund Committee and sub-committees. SCF finances pilot methods with prospect for scaling up. CTF funds the demonstration, deployment and transfer of low carbon technologies.	Current pledges: CTF – US\$ 4.8 billion. SCF – US\$ 1.6 billion including USD 735 million for Pilot Program for Climate Resilience, US\$ 406 million for Forest Investment Program, and US\$ 292 m for scaling up renewable energy.

Clean Development Mechanism (2006)	Encourages implementation of emission reduction measures in developing countries.	Projects receive credits (CERs) for verified emission cutbacks that are sold to entities in developed countries for compliance with Kyoto Protocol commitments.	While the number of CERs issued and their market price is well known, amounts received by developing countries are not known. Annual flows estimated at US\$ 3 to 10 billion.
b. Catalytic Uses at the Country Level			
Patent Solutions	The idea is for donors to facilitate increased technological transfers, thereby augmenting capacity and access in the developing world.	Buying out or pooling together assets via patent pools and patent buy-outs.	Patent Buy-Outs or Patent Pools are not designed to raise additional revenue. Rather, their additionality lies in their ability to solve a longstanding development problem.
Advanced Market Commitments	Stimulate the development and manufacture of affordable vaccines for developing countries	Donors commit funds for the purchase of a new vaccine, incentivising manufacturers to invest in vaccine development and production. Manufacturers commit to supply the vaccine at a lower, pre-agreed price in the long term.	US\$ 1.5 billion pledged by 5 donors and Bill & Melinda Gates Foundation for AMC for pneumococcal disease.

Source: OECD (2010) and author

Appendix C: Evaluation Methodology Linkages

With a view to reconstructing the program theory, a number of “if-then” statements comprise the linkages. Here the evaluation had to work backwards, starting with the identification of the overall objectives (global impacts) for the intervention to achieve, i.e. the overarching goals pursued by all the external aid activities of the Commission. These are derived from a number of mutually supporting and interlinked EU strategy documents. The following is an overview of these objectives and the respective documents in which they are outlined:

- i. **Poverty reduction in the context of sustainable development** (including MDGs) is one of the overarching objectives of the Commission’s external assistance. This includes the pursuit of the MDGs, as outlined in various official documents such as the EU Treaty, the Cotonou Agreement, partnership agreements, and reaffirmed in the European Consensus on Development (EU 2006).¹⁵⁰
- ii. **Delivery of global public goods**, such as environment, peace and security, grounded in a rules based framework. This is a key objective of the EC as outlined in the Treaty establishing the European Union, as well as in the Treaty establishing the European Community. Since it concerns global development challenges, this objective goes beyond the development objectives that can be pursued bilaterally. Article 11 of the EU Treaty clearly defined this to be an overall objective of the EU’s external relations.¹⁵¹ Moreover, it is reiterated in the European Consensus.¹⁵²

¹⁵⁰ §5 of the European Consensus on Development: “The primary and overarching objective of EU development cooperation is the eradication of poverty in the context of sustainable development, including pursuit of the Millennium Development Goals”.

¹⁵¹ “The Union shall define and implement a common foreign and security policy covering all areas of foreign and security policy, the objectives of which shall be: to safeguard the common values, fundamental interests, independence and integrity of the Union in conformity with the principles of the United Nations Charter; to strengthen the security of the Union in all ways; to preserve peace and strengthen international security, in accordance with the principles of the United Nations Charter, (...); to promote international cooperation; to develop and consolidate democracy and the rule of law, and respect for human rights and fundamental freedoms. (...)”

¹⁵² § 107 of the European Consensus on Development: “The Commission will continue to contribute to global initiatives that are linked to the MDGs and to global public goods. Global initiatives and funds are powerful instruments for launching new political measures or reinforcing existing ones where their scope is insufficient. They are capable of generating public awareness and support more effectively than traditional aid institutions.

- iii. **Improving global governance** is another key principle of the EU's external relations, being affirmed in the Treaty establishing the Union (Art 177.3), as well as the European Consensus. Finally, it is also recognized in the Commission's Communication on "The choice of multilateralism" (European Commission 2003).

Next, determining whether the inputs and the operational objectives (outputs) contribute to overarching goals (global impacts) of the highest level in the objectives diagram is determined through a string of intermediate (outcomes) and specific objectives (results). First, as demonstrated in the diagram above, the third layer of the intervention model lists a number of specific objectives. These objectives were based on the documents governing the channelling of the donor grant, including the Communications from the Commission to the Council and the EU Parliament following the Monterrey Consensus and the Paris Declaration on Aid Effectiveness, as well as the Communication (European Commission 2004) on the Monterrey Consensus and the Communication (European Commission 2006) on Financing for Development and Aid effectiveness. What is more, these objectives were later also reiterated in the European Consensus on Development.

Finally, the intermediate objectives were key determinants behind the Commission's decision to channel its funds. These objectives are supported by a series of high-level documents and international commitments, namely:

- i. **Scaling up of development efforts:** The Commission made a binding promise to scale up development assistance at the Monterrey Conference, followed up by a Communication on this commitment (European Commission 2004). Moreover, in 2005 the G8 dedicated itself at the Gleneagles Conference to double its development aid by 2010.¹⁵³
- ii. **Enhancing the efficiency and effectiveness of the Commission's and international development assistance:** The intermediate objectives relating to efficiency and effectiveness are clear goals of the international donor community and

This kind of aid should be aligned with national strategies, contribute to the dialogue with countries and aim at the integration of funds into their budget cycles."

¹⁵³§ 27 of the G8 Gleneagles summit: "The commitment of the G8 and other donors will lead to an increase of Official Development Assistance to Africa of \$25 billion a year by 2010, more than doubling aid to Africa compared to 2004."

the European Commission. These commitments emerged from the sequence of roundtables and commitments on harmonisation: Washington, Rome, Marrakech, Paris.¹⁵⁴ What is more they are reaffirmed in the European Consensus on Development.¹⁵⁵

- iii. **Consolidating the multilateral system while upholding EU policies and priorities:** This is a fundamental objective of the European Community's Development Policy as stated in Communication from the Commission to the Council and the European Parliament (European Commission 2000), as well as in the European Consensus on Development.¹⁵⁶ Furthermore, this objective is reasserted by the EC Communication on "The choice of multilateralism" (European Commission 2003).

The EQs also addressed the five evaluation criteria (relevance, efficiency, effectiveness, impact and sustainability) of the Development Assistance Committee of the OECD. The DAC definitions for these are outlined in Figure A. 6 below (OECD 1990, OECD 2010).

Figure A. 6: DAC Evaluation Criteria

a. Relevance
The extent to which the aid activity is suited to the priorities and policies of the target group, recipient and donor.
b. Effectiveness
A measure of the extent to which an aid activity attains its objectives.

¹⁵⁴See §1 and §3 of the Paris Declaration on Aid Effectiveness: "As in Monterrey, we recognise that while the volume of aid and other development resources must increase to achieve these goals (MDGs), aid effectiveness must increase significantly as well to support partner country efforts to strengthen governance and improve development performance." (§1) "We are encouraged that many donors and partner countries are making aid effectiveness a high priority, and we reaffirm our commitment to accelerate progress in implementation, especially in the following areas: (...) iv. Eliminating duplication of efforts and rationalising donor activities to make them cost-effective as possible." (§3).

¹⁵⁵See § 25 of the European Consensus on Development: "As well as more aid, the EU will provide better aid. Transaction costs of aid will be reduced and its global impact will improve. The EU is dedicated to working with all development partners to improve the quality and impact of its aid as well as to improve donor practices, and to help our partner countries use increased aid flows more effectively."

¹⁵⁶European Commission (2000 p.16): "The special features and value added of Community policy can be identified as follows in relation to the IFIs and other multilateral bodies: The Community's competence is not only on financial and technical aid, but extends to trade, economic and monetary matters and to political issues. This enables it to incorporate these various aspects into development cooperation processes."

c. Efficiency
Efficiency measures the outputs (qualitative and quantitative) in relation to the inputs. It is an economic term which signifies that the aid uses the least costly resources possible in order to achieve the desired results.
d. Impact
The positive and negative changes produced by a development intervention, directly or indirectly, intended or unintended. This involves the main impacts and effects resulting from the activity on the local social, economic, environmental and other development indicators. The examination should be concerned with both intended and unintended results and must also include the positive and negative impact of external factors.
e. Sustainability
Sustainability is concerned with measuring whether the benefits of an activity are likely to continue after donor funding has been withdrawn.

To measure the VfM at the results level, the thesis used the seven pre-defined development targets and their related indicators, as agreed per the Financing Agreement between the EC and the IDC (for the RCF2). Given the EC aligns itself with the recipient government policy, these indicators are predominantly designed to support the empowerment of Historically Disadvantaged Persons (HDP's) through BEE SME equity support (see Figure A. 7).

Figure A. 7: RCF Performance Target

1. SME Funding	Approximately 70 SMEs should be funded from the EUR 47 million grant through investments as equity or quasi-equity. Simultaneously the investees would benefit from a business support services programme funded by a EUR 5 million grant from IDC.
2. Employment Creation	The RCF Programme should create 6000 new jobs, of which 30% are to be held by women.
3. Self Sustainability	The RCF should be revolving and self-sustainable.
4. HDP Empowerment	The investee should increase HDP empowerment through shareholding and possible access to management positions but also will have to achieve a 25.1% HDP ownership within one year from investment.
5. Access to Business Support	Access and use of BSS should be implemented to improve effective assistance to SMEs (i.e. training, technical assistance and monitoring).

6. Environment and HIV Awareness	Environment and anti HIV activities will be actively encouraged. Investees shall set up an environment and HIV/AIDS protection plan in accordance with the South African law.
7. Expanding Reach	Fifteen investments shall involve SMEs active in the rest of Africa, to provide a minimum of 500 HDP jobs.

These linkages between, on the one hand, the five EQs and, on the other hand the five DAC criteria, as well as the seven predefined results, are illustrated in Figure A. 8 below ('X' for covered).

Figure A. 8: Linkages Between Evaluation Targets

	EQ 1 Scaling Up/Additionality	EQ 2 Follow Up and Coherence	EQ 3 Results and Impact	EQ 4 Expertise	EQ 5 Imp. and Costs	All EQs
DAC Criteria						
DAC 1 Relevance				X		X
DAC 2 Effectiveness	X	X	X	X	X	X
DAC 3 Efficiency			X		X	X
DAC 4 Impact	X	X	X			X
DAC 5 Sustainability			X			X
R 1 SME's Funded			X			X
R 2 Employment Creation			X			X
R Self-Sustainability			X		X	X
R4 HDP Empowerment			X			X
R 5 Access to Business Support			X			X
R 6 Environment and HIV Awareness			X			X
R 7 Expand Reach			X			X

Appendix D: Description of South African SME Sector

The SME sector in South Africa is considered crucially important to facilitating future poverty reduction and is regarded as having the largest potential for future growth and employment creation in the country. According to the DTI, SMEs are classified as outlined in Figure A. 9.

Figure A. 9: South Africa SME Classification

Sectors	Classification	Total Full time equivalent of paid employees (Less than)
All but agriculture	Medium	200
	Small	50
	Very small	20
	Micro	5
Agriculture	Medium	100
	Small	50
	Very small	10
	Micro	5

Source: DTI (2009).

Appendix E: RCF Portfolio Data and EIB Pricing Model

Figure A. 10: Calculating the Financial Sustainability of the RCF (Assumptions)

PERTINENT ASSUMPTIONS		
Fund performance based on actuals as per date (September 2011)		
Scenarios Chosen		
Exclude tax during forecast period	Yes	
Exclude budgeted upside (% of turnover)	Yes	
Exclude tax during cash flow period	Yes	
Write-offs level	30.0%	
IDC management fees on reflows received	10.0%	
Include write off level in nominal cash flow	Yes	
Include IDC management fees in nominal cash flow	Yes	
Budgeted RATIRR	Direct	Niche
Loan	5.0%	10.0%
Shares	5.0%	n/a
Upside (as % of capital disbursed)	14.0%	14.0%

Source: IDC (2011).

Figure A. 11: RCF1 Portfolio Overview

RCF1 PORTFOLIO (30 June 2011)			
Reflows			
Total reflows		131,127,205	
Interest		23,852,352	
Total		154,979,556	
Deductions			
IDC management fees		8,246,930	
Funds available post management fees		146,732,626	
Refund to RDP account		37,843,283	
SAIPF disbursements		13,552,874	
Net funds available		95,336,469	
CHANNELS			
	Direct	Niche	Combines
Committed funding	213,400	63,634	277,034
Disbursements	213,400	56,056	269,455
Actual and forecasted reflows	290,144	171,367	461,512
Actual and forecasted leakages	62, 654	57,233	119,887
Nominal cash flow	14,091	50,500	64,591
Nominal IRR	1.0%	10.6%	3.4%

Source: IDC (2011).

Figure A. 12: Calculating the Financial Sustainability of the RCF1

BUDGETED FUNDING (ZAR000)			
	Direct	Niche	Combined
Uncommitted budgeted fund performance			
Budgeted disbursement	112,242	22,521	134,763
Budgeted reflows	184,906	139,928	324,834
Capital repaid	112, 242	22,521	134,763
Interest/Dividend	41,286	--	41,286
Final bullet	31,378	117,407	148,785
Sweetener	--	--	--
Budgeted leakages	68,415	51,773	120,189
IDC fees on reflows received	12,943	9,795	22,738
Potential tax liability	--	--	--
Write offs	55,472	41,978	97,450
Nominal cash flow	4,248	65,634	69,882
Nominal IRR	1.0%	17.4%	7.6%
COMMITTED FUNDING			
	Direct	Niche	Combined
Aggregate fund performance to date			
Committed disbursement	185,307	105,000	290,307
Actual and forecasted reflows	369,034	379,352	748,386
Capital repaid	180,992	105,000	285,992
Interest/Dividend	110,658	266,052	376,710
Final bullet	77,309	8,300	85,609
Sweetener	75	--	75
Actual and forecasted leakages	132,771	140,055	272,826
IDC fees on reflows received	26,251	26,589	52,840
Potential tax liability	--	--	--
Write offs	106,520	113,466	219,986
Nominal cash flow	50,956	134,297	185,253
Nominal IRR	4.2 %	11.7%	7.5%

Source: IDC (2011).

Figure A. 13: Calculating the Financial Sustainability of the RCF2

AGGREGATE FUND PERFORMANCE (21 Oct. 2011)			
	Direct	Niche	Combines
Actual forecasted and budgeted disbursements	297,549	127,521	425,070
Actual disbursements to	137,020	28,952	165,972

date			
Actual reflows received to date	13,967	1,132	15,099
Combined actual, forecasted and budgeted reflows	553,940	519,280	1,073,220
Capital repaid	293,235	127,521	420,756
Interest/dividend	151,944	266,052	417,995
Final bullet	108,687	125,707	234,394
Sweetener	75	--	75
Actual, forecasted and budgeted leakages	201,187	191,828	393,015
IDC fees on reflows received	39,195	36,384	75,578
Potential tax liability	--	--	--
Write-offs	161,992	155,444	317,436
Nominal cash flow	55,205	199,931	255,135
Nominal IRR¹⁵⁷	3.4%	12.8%	7.6%

Source: IDC (2011).

¹⁵⁷ Measured to 31 December 2030.

Appendix F: Sample Survey Questionnaire and Responses

The questionnaire identifies five overarching Evaluation Questions (EQ), which are broken down into Judgment Criteria (JC) and Indicators (IC). The following is a sample of the responses received to the questionnaire over the course of the evaluation.

Figure A. 14: Sample Survey Response

EQ1	Did the channelling contribute to scaling up of aid?
EQ 1 – SU	EQ 1 Scaling Up
Rationale for question	The question aims at verifying critical aspects allowing an assessment of whether the channelling of EC funds has contributed to a scaling-up of aid, first by permitting the use of existing resources in such a way that takes advantage of the absorption capacity of the IDC, second by attracting other donors, third by mobilising additional (types of) financial resources and enabling more financing instruments, and finally by facilitating attainment of the critical mass necessary for certain interventions.
Link to Program Theory	This question mainly relates to effectiveness and impact insofar as it aims at verifying the transformation of outputs (e.g. benefit of absorption capacity/attract financial resources) into results (achieve critical mass of funding) and ultimately intermediate impacts (scale up development efforts).
JC1.1	Has the absorption capacity of the interventions facilitated the disbursement of EC funds?
I-1	In your opinion, did the absorption capacity of the interventions facilitate the disbursement of EC funds?
Answer:	Yes, to some extent (referring specifically to RCF1). This is because the disbursement of EC funds took longer than planned and involved the extension of implementation period of the Programme. RCF1 commenced in Jan 1007 and its implementation should have ended in Dec 1009. However, the Programme had to be extended by two years and implementation now ends in Dec 1011 with closure expiring in Dec 1013. During the implementation of the Programme, we found that the absorption capacity of the IDC was constrained by various factors including: (1) the reliance by the RCF unit of IDC on IDC's mainstream business units for deals and no direct marketing by RCF to the target SMEs (of course with the exception of niche funds); (1) too many rigid criteria in the Financing Agreement and Investment guidelines which needed a long EC process to amend thus not allowing the IDC to adapt quickly to the market needs; and (3) the use of a channel (that is the 'third party channel' - working through other financial institutions) which turned out not to be feasible in the implementation of the Programme). This said, the full EC funds (3 tranches) have been fully disbursed following the very satisfactory performance by the IDC in terms of achieving the developmental indicators. Indeed, RCF1 is one of the highly performing EC programmes despite the delays in disbursement.

JC 1.1	The presence of the EC/EIB has attracted/mobilised more resources?
I-1	In your opinion, did the presence of the Commission encourage other donors to contribute?
Answer:	No, because RCF was set up as a ring-fenced fund which did not allow other donors to participate. It might have been a good idea but it would involve amending the Financing Agreement.
I-1	In your opinion, did the Commission's grants allow for the mobilisation of other types of funding (e.g. loans, interest rate subsidies...)?
Answer:	Yes, the presence of the Commission's grants provided the flexibility for the IDC to use a wide range of risky financial instrumentals. Recall that RCF contributes up to 50% of the financing on a particular deal and this is normally not secured with collateral etc. The IDC is entitled to use the most appropriate deal to enable suitable investments to take place provided that the deals are for BEE SMEs and look promising in terms of empowerment for HDPs (historically disadvantaged persons especially women).
JC 1.3	EC contributions facilitated attainment of the critical mass necessary for the interventions?
I-1	In your opinion, has Commission funding made a difference?
Answer:	To a high degree as confirmed by the MTR and the 1010 results oriented monitoring (ROM) report. The developmental indicators (jobs, women, HIV-AIDs, HDP managers etc) are progressing very well. But more important is the culture shift that has taken place at IDC due to the presence of RCF: RCF has led to the RCF's business unit specialization in marginalized funds and the unit is now managing four of these types of funds including the "Transformation and Entrepreneurship Scheme (TES) etc thanks to RCF. In addition, RCF introduced the culture of Business Support Services (BSS) which has now been mainstreamed into IDC.
I-1	In your opinion, would the critical mass necessary for the interventions have been reached without the EC contributions?
Answer	No, without the EC funding, the deals made by RCF would not have taken place as IDC would have been averse to taking these risks (typically banks prefer to give senior secured lending). The key value added of RCF is to enable investments which would not normally take place due to perceived high risks, high transaction costs etc to take place. Recall that RCF funding is unsecured.
JC 1.4	ODA has been scaled up since the channelling took place?
I-1	Briefly outline the evolution of Commission channelling to South Africa.

Answer	Difficult to answer but note that the Commission has been present in SA since 1995 (after independence) and has increased its budget resources to SA through its various Multi-annual Indicative Programmes (MIPs). A key challenge in SA is the need to reduce the wide inequality between the rich and the poor vis a vis employment, service delivery etc. In terms of private sector and specifically RCF, the EC's Country Strategy Paper (CSP) for SA 1000-1001 saw the development of the SME sector as a key focal area for support. A key challenge in the private sector was noted as being to reduce the gap between the country's first world economy and the third world economy. SME development in particular for HDPs is seen as an important instrument for employment creation. Subsequent SA CSP's have maintained the overriding priority of employment creation including the development of the private sector in particular SMEs.
I-1	Is there any evidence that channelling through the IDC has increased ODA in the country? If so please indicate.
Answer	Not sure, although I am aware that various donors are working jointly with the IDC as it is a key and successful DFI in SA. KfW, AFD and EIB all work jointly with IDC.
EQ2	Did the donor ensure coherence of development objectives pursued and was he capable of following up on results when providing grant finance to the RCF? How did this compare to the provision of the EU's global PSD financing?
EQ 2 – IR	EQ 2 Follow Up and Coherence
Rationale for question	The question aims at verifying the existence of clearly-identified expected results and their coherence with those of the channelling instrument; - the capacity of the Commission Services that channel the funds to follow up their use, and effective follow-up by the Commission Services of the use made of the funds by the partners; - the existence of information on the results achieved. The question is fundamentally one of the effectiveness of the process since the existence of information on materialisation of results depends substantially on the process.
Link Program Theory to	The question aims at providing insights in terms of monitoring of the channelled funds. With regard to the reconstructed program theory, this question corresponds to the results and outcomes level, addressing issues of <i>effectiveness and sustainability</i> .
JC2.1	The objectives the Commission aimed to achieve via a specific intervention were explicit and coherent with those of the channelling instrument selected?
I-1	Please indicate any evidence that the Commission subscribes to the overall objectives of the intervention (documents, etc).
Answer	The Financing Agreement (FA) is a binding contract between the SA government and the EC confirming their joint agreement to the objectives of the agreement.
I-2	Was a justification given in the preparatory documents and agreements?
Answer	Yes, see my afore-mentioned comments regarding the feasibility study.

I-2	What was the amount of funds earmarked and impact on channelling instruments' objectives?
Answer	RCF1 - EUR 58.901 million and RCF2 - EUR 50 million. The provision of EUR 100+ million (approx. ZAR 800 million) allowed for a sizeable investments into the BEE SME sector leading to significant job creation/empowerment in this sphere. The fact that IDC co-finances RCF deals increases the leverage of RCF and enhances aid effectiveness.
JC 2.2	The Commission Services which channel the funds have the capacity, resources and information needed to follow up their use?
I-1	Please indicate the resources in manpower and time allocated to these functions.
Answer	Yes indeed. At the Delegation, there are 2 people closely involved in RCF: (1) Project Officer (myself) who maintains a close relationship with Programme involving following up on implementation, including attending Programme Steering Committee (PSC) meetings on a quarterly basis; (2) a Head of Section (Berdos) who oversees the Project Officer; and (2) the Head of Development Cooperation (Richard Young) who oversees the overall implementation of EC development aid in SA. Indeed there is also the Head of Finance and Contracts and subordinates who oversee all contractual issues. But their relationship to the Programme is a bit more distant.
I-2	Did the managers of the channelling instruments demonstrate effective transmission of the agreed monitoring documents?
Answer	Yes, detailed monitoring reports are prepared by the IDC on a quarterly and annual basis in line with PSC meetings. The reports demonstrate the evolution of the Programme to date. The reports provide assurance of the IDC's professionalism in managing the Programme. In addition, the EIB makes presentations during the PSC meetings which demonstrate the quarterly and annual progress. In addition the EIB prepares annual performance review reports reflecting on the IDC's management of the Programme.
JC 2.2	The Commission Services who channel the funds effectively follow-up the uses of the funds by the managers of the channelling instruments and interact with these managers?
I-1	Does an internal follow up reports in the relevant Commission Services exist?
Answer	Yes, the Project Officer follows up on critical issues on a timely basis and coordinates with the relevant structures within the Commission. The EIB TA is instrumental in providing technical advice to the Project Officer (PO) especially on how to address 'challenging' matters.
I-2	Please indicate any evidence of interactions (notes, meetings, etc.) with the managers of the channelling instruments on the evolution of the activities funded.
Answer	There are quarterly and annual reports since 2007. Please indicate if you wish to see these reports.
JC 2.4	Information on the results achieved is available at the Commission
I-1	Are evaluations conducted and their results communicated to the Commission Services?

Answer	Yes, an MTR was conducted in Oct-Nov 2009 for RCF2. The results were communicated to BXL as part of the payment analysis justifying the payment of the third tranche (EUR 12.5 million). The MTR was a precondition for the payment of the third tranche. In addition, the results of the ROM are always communicated to BXL, e.g. for the 2010 ROM. Lastly, a MTR and final evaluation of RCF1 were also conducted and communicated to BXL.
EQ3	EQ3: To what degree did channelling to this innovative facility contribute in a sustainable manner to achieving the intervention objectives the donor targeted when channelling its funds?
EQ 3 – IR	EQ 3 Impacts and Results
Rationale for question	The question aims at verifying whether the intended results and impacts from the intervention supported with channelled funds have materialized and, moreover, whether they have done so in a sustainable manner. More specifically the question aims at verifying whether the RCF generated in a sustainable manner the results and impacts the Commission expected when contributing to the intervention. The question is of the utmost importance for the evaluation since the extent of the results and impacts at beneficiary level is the ultimate justification for channelling aid. It is also an extremely difficult question to answer and it will be addressed stepwise through the various judgment criteria. These will verify: - the existence of information on the results achieved; - the adequacy of the observed results in relation to expectations; - the coherence between the objectives of the intervention and the Commission's overall policies. The question is fundamentally one of effectiveness and impact but cannot avoid an analysis of the process since the existence of information on materialisation of results depends substantially on the process.
Link to Program Theory	The question concerns mainly effectiveness, impact and sustainability and deals with the two highest layers of the intervention model diagram.
JC 3.1	Information on the results achieved is available at the Commission
I-1	Are evaluations conducted and their results communicated to the Commission Services?
Answer	Yes, an MTR was conducted in Oct-Nov 2009 for RCF2. The results were communicated to BXL as part of the payment analysis justifying the payment of the third tranche (EUR 12.5 million). The MTR was a precondition for the payment of the third tranche. In addition, the results of the ROM are always communicated to BXL, e.g. for the 2010 ROM. Lastly, a MTR and final evaluation of RCF1 were also conducted and communicated to BXL.
JC 3.2	The Commission's objectives for the intervention have been sustainably achieved
I-1	Please indicate any documentary evidence on degree of sustainable achievement of the Commission's objectives.
Answer	Please see the MTR report and the ROM report which indicate positive progress of RCF2 objectives. I can also share with you the quarterly report after the PSC meeting on 17th August 2011 which will have the latest information.

I-2	In your opinion, what are the views of stakeholders (project managers, beneficiaries, other donors, partner countries) on the achievement of results?
Answer	Very positive, see the aforementioned reports.
I-2	Is there any evidence of overall positive impact on beneficiaries? If so, please indicate.
Answer	It is still too early to measure impact at this stage. When investments are made by IDC, they calculate expected jobs, women managers etc. But it is only with time that one can verify the actual impact. IDC aims to conduct annual monitoring missions to each investee to measure actual impacts. One mission was conducted in 2010 but it was not to all investees, hence the information is not too reliable. Another mission is planned in 2011 which should cover all investees.
JC 3.3	Are the overall set of objectives of the intervention (on paper and in reality) are in line with the Commission's policies?
I-1	Please indicate any outstanding questions to be raised on alignment of interventions with Country and Regional Strategy Papers?
Answer	N/A.
I-2	Please indicate any outstanding questions to be raised on overall objectives of the intervention vis-à-vis Commission's overall policies?
Answer	N/A. The intervention is in line with Commission development objectives.
EQ4	To what extent did engaging in Risk Capital Financing expand the EC's development assistance expertise compared to the traditional LED KZN?
EQ 4 – E	EQ 4 Expertise
Rationale for question	The question aims at verifying the extent to which the channelling of funds has allowed the Commission to gain access to specific expertise or instruments so as to better respond to the needs of beneficiaries. Indeed, it is expected that channelling allows the Commission to contribute to offering expertise which would not be readily available in-house. This also applies to the capacity of channelling to provide, for instance through a combination of grants and loans, a mix of the specific expertise of different donors that could not be achieved otherwise.
Link Program Theory to	The question relates to three evaluation criteria: relevance (responding better to beneficiaries' needs); the 3Cs (the channelling as a means of combining the comparative advantages of donors); and added value, both for the Commission (as it is expected to widen the range of what it can offer) and for the beneficiaries (as the intervention should allow a better response to their needs).
JC4.1	Channelling through the IDC enables the Commission to provide leading expertise and experience to beneficiaries?
I-1	In your opinion, to what extent does the IDC possess technical/sector leadership in area of intervention?

Answer	The IDC is a proven leader in the area of development finance in SA. As a matter of fact, the two most important DFIs in SA tasked with leading development in the country are IDC and DBSA. The RCF feasibility study further confirmed IDC as the best parastatal to manage RCF due to it: Having as a primary objective the generation of balanced, sustainable economic growth in SA; Having a strong business culture (regarded as the strongest of the funding parastatals) and historically a proven commercial track record; Already having embarked on providing risk capital funds and having created the infrastructure to handle this; and As an organ of the State being part of the implementation of the Government's economic / developmental policies. Having a proven track record and the fact that it operates nationally, is already materially involved with SME finance and Private Equity / Venture Capital.
JC 4.2	Channelling through FIs enables the Commission to have access to readily available know-how required to intervene in situations of emergency?
I-1	How many years of experience does the IDC have in the country and/or expertise in the field?
Answer	Not sure, but I think about 100 years.
JC 4.3	Channelling through IDC enables the Commission and the partner to provide more flexible and comprehensive (financing) instruments?
I-1	What is the number of financial instruments that the Commission alone can provide?
Answer	N/A
I-2	What is the number of financial instruments that the IDC alone can provide?
Answer	N/A
I-3	What is the number of financial instruments that the Commission and IDC can provide together?
Answer	N/A
EQ5 Implementation Cost	To what extent did the Commission's channelling of funds contribute to swifter implementation and lower transaction costs?
EQ 5 – IC	EQ 5 Implementation/Cost
Rationale for question	The question verifies whether channelling through local institutions such as the IDC is an effective and efficient alternative to the Commission's own direct interventions, in terms of "time to market" and cost reduction.
Link Program Theory to	The question relates to effectiveness and efficiency in implementation of projects and programmes, and to efficiency in terms of reducing transaction costs. Through these two aspects it also addresses value added, notably for the beneficiary but also for the Commission.
JC5.1	Time needed between project identification and project implementation
I-1	How much time did it take from first identification study of the project to the proposal decision?
Answer	Not sure exactly how much time it took. But from the records, I note that the feasibility study for RCF1 was finalised in June 2000 while the Commission Decision was taken on 27th December 2001 (which is 1 12 years). That is more or less the standard timeframe between identification and/or formulation and the Commission Decision.

I-2	How much time did it take from proposal decision to signature of Contribution Agreement EC-IDC?
Answer	There is no EC-IDC agreement. The Financing Agreement is signed between the EC and the DTI (representing the government of SA). In the case of RCF1, the Commission Decision was taken on 27th Dec 2001 while the EC-DTI Agreement was signed by DTI on 9th March 2002 (about 2 ½ months gap). In the case of RCF2, the Commission Decision was taken on 14th December 2004 while the EC-DTI Agreement was signed by the DTI on 28th February 2006 (2.4 months gap). NB: when the Commission takes the Decision, it signs the Financing Agreement (FA) the same day. Hence the Commission Decision date is synonymous with its signature of the FA.
	There is another EC-EIB MOU regarding technical assistance (TA) for the Programme and another Memorandum of Agreement (MOA) between the EIB and IDC regarding management of the Programme. The latter two took about 11 months to be signed after the signing of the EC decision (EC decision was taken on 14 Dec 2004 and the two agreements were finalised in November 2006).
I-3	How much time did it take from signature of Contribution Agreement to signature of contract for implementation? Was this in line with expectations?
Answer	See previous answer. Contract for implementation is between the IDC and EIB and this was signed in Nov 2006, 11 months after the Commission Decision. Not sure if it was in line with expectations but past experience within EC proves such a time lag between Commission Decision and actual start of implementation.
JC 5.2	Transaction costs are reduced for the Commission and the beneficiaries
I-1	How do interventions involving channelling through multilateral development banks vs. direct interventions measure up with regards to management costs for the Commission?
Answer	In the case of RCF, management costs for EC are negligible as we work through an existing expert institution (IDC) in collaboration with an international leader (EIB). The latter was chosen by the Commission with a view to utilizing the EIB's wide experience in handling small scale financing operations in the commercial sector outside the EU. Working with the IDC and EIB and using Sector Budget Support (which necessitates the use of government procedures) has been the most cost effective and efficient way of managing the Programme. In the case of RCF2, this way of implementation has enabled the use of the bulk of EC grants (EUR 47.23 million compared to the total package of EUR 40 million) to fund SMEs. EUR 2.4 million (negligible amount) is allocated to EIB TA while the rest (about EUR 400,000.00 goes to evaluations).
JC 5.3	The channelling entity uses procedures that are in line with the Commission's expectations
I-1	Was the project cycle to deliver aid through the channelling entities done on the basis of an existence of appropriate rules and procedures (e.g. framework and administration agreements)?

Answer	The channelling through IDC was done on the basis of fulfilling the Sector Budget Support eligibility requirements which includes the existence of sound financial management systems at DTI and IDC. Also, see my aforementioned comment in Section 1.3 regarding the 4-pillar and 6-pillar assessments.
I-2	Were/are the terms of the framework and administration agreements respected?
Answer	N/A.
JC 5.4	The intervention has been implemented at a reasonable cost
I-1	What is the assessment of efficiency of the interventions in monitoring and evaluation reports?
Answer	Not sure, perhaps IDC can answer. I understand that the monitoring requirements in terms of quarterly and annual reports etc, which are beneficial for the Commission, are a bit overwhelming for the IDC.